[JOINT COMMITTEE PRINT]

GENERAL EXPLANATION

OF THE

REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

(H.R. 4961, 97TH CONGRESS; PUBLIC LAW 97-248)

PREPARED BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

DECEMBER 31, 1982

U.S. GOVERNMENT PRINTING OFFICE
11-324 O WASHINGTON : 1983 JCS-38-82

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402

J862-1

CONGRESS OF THE UNITED STATES

(97th Cong., 2d Sess.)

JOINT COMMITTEE ON TAXATION

Senate	House
ROBERT DOLE, Kansas, *Chairman*	DAN ROSTENKOWSKI, Illinois, *Vice Chairman*
BOB PACKWOOD, Oregon	SAM GIBBONS, Florida
WILLIAM V. ROTH, JR., Delaware	J. J. PICKLE, Texas
RUSSELL B. LONG, Louisiana	BARBER B. CONABLE, JR., New York
HARRY F. BYRD, JR., Virginia	JOHN J. DUNCAN, Tennessee

MARK L. MCCONAGHY, *Chief of Staff*
DAVID H. BROCKWAY, *Deputy Chief of Staff*
JAMES W. WETZLER, *Chief Economist*

CONTENTS

Page
LETTER OF TRANSMITTAL 1
I. LEGISLATIVE HISTORY OF THE ACT 3
II. SUMMARY OF REVENUE PROVISIONS OF THE ACT 7
  A. Individual Income Tax Provisions 7
  B. Business Tax Provisions 7
  C. Compliance Provisions 9
  D. Pension Provisions 9
  E. Insurance Provisions 10
  F. Employment Tax Provisions 10
  G. Excise Tax Provisions 10
  H. Other Provisions 11
  I. Revenue Effect 12
III. GENERAL REASONS FOR REVENUE PROVISIONS 13
IV. GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE ACT 16
  A. Individual Income Tax Provisions 16
    1. Alternative minimum tax (sec. 201) 16
    2. Limitation on deduction for medical expenses (sec. 202) 24
    3. Limitation on deduction for non-business casualty losses (sec. 203) 26
    4. Taxation of unemployment compensation (sec. 611) .. 28
  B. Business Tax Provisions 30
    1. Corporate tax preferences (sec. 204) 30
    2. Basis adjustment for investment tax credits (sec. 205(a) 35
    3. Limitation on investment tax credit (sec. 205(b)) 38
    4. Accelerated cost recovery system (ACRS) changes for 1985 and 1986 (sec. 206) 39
    5. Construction period interest and taxes (sec. 207) 41
    6. Modification to leasing rules (secs. 208–210) 45
      a. Safe harbor leasing rules 54
      b. Changes to non-safe harbor leasing rules 63
    7. Foreign tax provisions 68
      a. Limitation on credit for foreign income taxes imposed on foreign oil extraction income and current taxation of foreign oil-related income (secs. 211 and 212) 68

IV. GENERAL EXPLANATION OF THE ACT—Continued
B. Business Tax Provisions—Continued
7. Foreign tax provisions—Continued

Page
b. Possession tax credit; income tax liability incurred to the Virgin Islands (sec. 213) 79
8. Tax-exempt obligations 97
a. Restrictions on tax-exempt bonds for private activities (secs. 214, 215, 216, and 219) 97
b. Other amendments affecting industrial development bonds (secs. 217, 218, and 221) 111
c. Amendments to the Mortgage Subsidy Bond Tax Act (sec. 220) 120
d. Revenue effect of tax-exempt bond provisions 123
9. Mergers and acquisitions 124
a. Partial liquidations (sec. 222) 124
b. Certain distributions of appreciated property (sec. 223) 129
c. Stock purchases treated as asset purchases (sec. 224) 131
d. Reorganizations constituting changes in form (sec. 225) 141
e. Use of holding companies to bail out earnings (sec. 226) 141
f. Application of attribution rules (sec. 227) 144
g. Waiver of family attribution rules (sec. 228) 145
h. Revenue effect of merger and acquisition changes 147
10. Completed contract method of accounting (sec. 229) 148
11. Accelerated corporate tax payments (sec. 234) 155
12. Amortization of original issue discount on bonds (sec. 231) 158
13. Stripping of interest coupons from bonds (sec. 232) 164
14. Extension and revision of targeted jobs credit (sec. 233) 168
C. Provisions Designed To Improve Taxpayer Compliance 172
1. Withholding on interest and dividends (secs. 301–308) 172
2. Improve information reporting 185
a. Reporting of interest (sec. 309) 185
b. Obligations required to be registered (sec. 310) 189
c. Returns of brokers (sec. 311) 194
d. Information reporting requirements for payments of remuneration for services and direct sales (sec. 312) 195
e. Reporting of State and local income tax refunds (sec. 313) 198

IV. GENERAL EXPLANATION OF THE ACT—Continued

C. Provisions Designed To Improve Taxpayer Compliance—Continued

2. Reporting provisions and penalty provisions to improve reporting generally—Continued

Page
f. Employer reporting with respect to tips (sec. 314) ... 199
g. Increased penalties for failure to file information returns or to furnish statements (sec. 315) ... 202
h. Increase in civil penalty on failure to supply identifying numbers (sec. 316) ... 204
i. Extension of withholding to certain payments where identifying number not furnished or inaccurate (sec. 317) ... 205
j. Minimum penalty for extended failure to file (sec. 318) ... 207
k. Form of returns (sec. 319) ... 208
3. Other penalty provisions ... 210
a. Penalty for promoting abusive tax shelters, etc. (sec. 320) ... 210
b. Action to enjoin promoters of abusive tax shelters, etc. (sec. 321) ... 212
c. Procedural rules applicable to assessible penalties for promoting abusive tax shelters, aiding and abetting the underpayment of tax, and frivolous returns (sec. 322) ... 214
d. Penalty for substantial understatement (sec. 323) ... 215
e. Penalties for aiding and abetting the understatement of tax liability (sec. 324) ... 219
f. Fraud penalty (sec. 325) ... 222
g. Penalty for frivolous returns (sec. 326) ... 223
h. Relief from criminal penalty for failure to file estimated tax where a taxpayer falls within statutory exceptions and adjustments to estimated tax provisions (secs. 327 and 328) ... 225
i. Criminal fines (sec. 329) ... 226
j. Special rules with respect to certain cash (sec. 330) ... 227
4. Administrative summonses ... 231
a. Special procedures for third-party summonses and third-party recordkeepers (secs. 331 and 332) ... 231
b. Limitation on use of administrative summonses (sec. 333) ... 234
5. Pension withholding and recordkeeping ... 237

IV. GENERAL EXPLANATION OF THE ACT—Continued

C. Provisions Designed To Improve Taxpayer Compliance—Continued

5. Pension withholding and recordkeeping—Con.

Page
a. Withholding on pensions, annuities, and certain other deferred income (sec. 334(a) and (d)) 237
b. Pension reporting and recordkeeping requirements (sec. 334(a) and (b)) 240
c. Partial rollovers of IRA distributions (sec. 335) ... 242
6. Foreign transactions 244
a. Access to records and persons not found in the United States (secs. 336, 337, and 342) 244
b. Penalty for failure to furnish information returns with respect to certain foreign corporation; reporting requirement for corporations controlled by foreign persons (secs. 338 and 339) .. 249
c. Returns with respect to foreign personal holding companies (sec. 340) 252
d. Authority to delay date for filing certain returns relating to foreign corporations and foreign trusts (sec. 341) 254
e. Technical amendments to section 905(c) (sec. 343) 254
7. Interest provisions 256
a. Daily compounding of interest (sec. 344) 256
b. Semi-annual determination of rate of interest (sec. 345) 257
c. Restrictions on payment of interest for certain periods (sec. 346) 258
8. Taxpayer safeguard provisions (secs. 347-350) 260
9. Other provisions 264
a. Disallowance of deductions for narcotics trafficking (sec. 351) 264
b. Report on forms (sec. 353) 265
c. Internal Revenue Service staff increases (sec. 352) 265
10. Tax treatment of partnership items (secs. 401-405) 267
11. Revenue effect of compliance provisions 282
D. Pension Provisions 283
1. Limits on contributions and benefits (secs. 235 and 245) 284
2. Loans to plan participants (sec. 236) 294
3. Parity under qualified plan rules for corporate and noncorporate employers; group term life insurance (secs. 237-250) 301
4. Retirement savings for church employees (sec. 251) ... 329
5. Certain State judicial retirement plans (sec. 252) 334
6. Contributions for disabled employees (sec. 253) 336
7. Participation in group trusts by governmental plans (sec. 254) 338
8. Revenue effect of pension provisions 339

IV. GENERAL EXPLANATION OF THE ACT—Continued

Page

E. Taxation of Life Insurance Companies and Annuities...... 340
  1. Repeal of modified coinsurance provisions (secs. 255-258)...... 340
  2. Policyholder dividends (secs. 259 and 263)...... 346
  3. Life insurance reserves (secs. 260, 263, and 267)...... 348
  4. Menge formula (secs. 261 and 263)...... 353
  5. Consolidated returns (secs. 262 and 263)...... 354
  6. Full deduction for amounts credited to annuity contracts (sec. 264)...... 356
  7. Tax treatment of deferred annuities (sec. 265)...... 360
  8. Flexible premium life insurance contracts (sec. 266)...... 366
  9. Grandfathering for treatment of indeterminate premium policies (sec. 263)...... 377
  10. Underpayments of 1982 estimated taxes (sec. 268)...... 378
  11. Revenue effect of insurance provisions...... 380
F. Employment Tax Provisions...... 381
  1. Independent contractors...... 381
    a. Alternative standards for determining classification of workers for employment tax purposes and extension of certain interim provisions (sec. 269)...... 381
    b. Reduction of certain employment tax liabilities where workers are reclassified as employees (sec. 270)...... 384
  2. Federal unemployment tax provisions...... 387
    a. FUTA tax rate and wage base (sec. 271)...... 387
    b. Allocation of FUTA revenues (secs. 271 and 275)...... 392
    c. Federal unemployment loans (secs. 272-274)...... 394
    d. Exclusions from Federal unemployment tax (secs. 276-277)...... 399
  3. Medicare coverage of, and application of hospital insurance tax to, Federal employment (sec. 278)...... 401
G. Excise Tax Provisions...... 403
  1. Airport and Airway Trust Fund taxes and trust fund transfers (secs. 279-281A)...... 403
  2. Temporary increase of excise tax on communication services (sec. 282)...... 410
  3. Temporary increase in cigarette excise taxes (sec. 283)...... 411
  4. Windfall profit tax provisions...... 413
    a. Elimination of the TAPs adjustment (sec. 284)...... 413
    b. Windfall profit tax on Alaska Native Corporations (sec. 291)...... 414
  5. Additional refunds relating to repeal of excise tax on buses (sec. 274)...... 415

IV. GENERAL EXPLANATION OF THE ACT—Continued Page
H. Miscellaneous Provisions 417
1. Exclusion from income of National Research Service Awards (sec. 285) 417
2. Annual accrual accounting method for corporate joint ventures of sugar producers (sec. 230) 419
3. Certain payments to foreign government officials or employees (sec. 288) 422
4. Debt management provisions (sec. 289) 424
a. Rate of interest payable on U.S. savings bonds 424
b. 4-percent limit on interest rate on bonds 426
5. Disclosure of tax returns 428
a. Disclosure of tax return information for nontax criminal investigation purposes (sec. 356) 428
b. Civil damages for unauthorized disclosure of returns and return information (sec. 357) 433
c. Disclosure of returns and return information for use in certain audits by the General Accounting Office (sec. 358) 434
6. Exemption of veterans organizations (sec. 354) 437
7. Exemption of amateur athletic organizations (sec. 286) 438
8. New Jersey revenue sharing allocation (sec. 287) 440
9. Relief for the Jefferson County Mental Health Center, Lakewood, Colo. (sec. 290) 442
10. Award of reasonable litigation costs where taxpayer prevails and government position was unreasonable (sec. 292) 444
11. Treatment of certain lending or finance businesses for purposes of the tax on personal holding companies (sec. 293) 451
V. REVENUE EFFECTS OF THE ACT 454

LETTER OF TRANSMITTAL

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON TAXATION,
Washington, D.C., December 31, 1982.

Hon. ROBERT DOLE, *Chairman,*
Hon. DAN ROSTENKOWSKI, *Vice-Chairman,*
Joint Committee on Taxation,
U.S. Congress, Washington, D.C.

DEAR MESSRS. CHAIRMEN: A committee report of a Congressional committee sets forth the committee's explanation of a bill as reported by that committee. In some instances, a committee report does not also serve as an explanation of the final provisions of the legislation enacted by the Congress. This is because the versions of the bill reported by the House and Senate committees may differ significantly from the versions of the bill passed by the House, passed by the Senate, or enacted after action by a conference committee.

The Tax Equity and Fiscal Responsibility Act of 1982, because of its comprehensive scope and the numerous changes which were made to the reported versions of the bill by the Senate and the conference committee, is an example of legislation with respect to which the differences between provisions of the reported bill and provisions of the public law are significant. This document represents an explanation of the revenue provisions of the Act as enacted (Public Law 97-248).

This document was prepared by the staff of the Joint Committee on Taxation, in consultation with the staffs of the House Committee on Ways and Means and the Senate Committee on Finance. It is comparable to similar material prepared by the Joint Committee staff with respect to other revenue acts in recent years.

The first part of the document is an overall chronology of the legislative background of the revenue provisions of the Act in the 97th Congress. (In addition to this overall chronology, specific references to the legislative background of each provision of the Act are set forth in footnotes accompanying the explanations of the provisions in the fourth part of the document.) The second part is a brief summary of the principal provisions of the Act. The third part presents the general reasons for the legislation. The fourth part consists of explanations of the provisions of the Act. The fifth part sets forth the estimated revenue effects of the Act for fiscal years 1983-1987 and for calendar years 1982-1987.

Sincerely yours,

MARK L. MCCONAGHY,
Chief of Staff.

I. LEGISLATIVE HISTORY OF THE ACT

The following is an overall chronology of the legislative background in the 97th Congress of the revenue provisions (titles II, III and IV, and sec. 611) of the Tax Equity and Fiscal Responsibility Act of 1982 (Public Law 97-248).[1]

H.R. 4961 as Passed by the House

- ***Reported by Ways and Means Subcommittee on Select Revenue Measures.***—November 13, 1981 (WMCP: 97-25). H.R. 4961 was introduced on November 13, 1981, and embodied 5 miscellaneous tax bills as amended by the Subcommittee: H.R. 2397, H.R. 2860, H.R. 3262, H.R. 4408, and H.R. 4908.[2] Subcommittee hearings were held on these bills, except for H.R. 3262, on October 19, 1981. A Subcommittee hearing on H.R. 3262 (relating to attorney's fees) was held on September 28, 1981.
- ***Markup by Committee on Ways and Means.***—November 19, 1981. The Subcommittee bill was amended later to include provisions of H.R. 4942 as agreed to by the committee (unemployment compensation and welfare provisions—title II of H.R. 4961 as reported).
- ***H.R. 4961 reported by the Committee on Ways and Means.***—December 14, 1981 (H. Rep. 97-404).
- ***H.R. 4961 passed by the House.***—December 15. 1981, by voice vote, under suspension of the rules.

H.R. 4961 as Passed by the Senate

- ***Senate consideration of certain provisions of House-passed H.R. 4961.***—On December 16, 1981, the Senate approved two provisions from the House-passed H.R. 4961 (relating to (1) rental of residences to family members and other business uses of residences and (2) 2-year postponement of effective date for 1976 Tax Reform Act rules on net operating losses) as amendments to H.R. 5159, the

---

[1] In addition to this overall chronology, specific references to the legislative background of each provision are set forth in footnotes accompanying the explanations of the provisions in Part IV of this document. These legislative background references include, as appropriate, citations to the following: H.R. 4961 as reported by the House Committee on Ways and Means (H. Rep. No. 97-404, December 14, 1981); H.R. 4961 as reported by the Senate Committee on Finance (S. Rep. No. 97-494, Vol. 1, July 12, 1982); Senate floor amendments, if any, to H.R. 4961 as reported by the Finance Committee; the Conference Report on H.R. 4961 (Joint Explanatory Statement of the Committee of Conference) (H. Rep. No. 97-760, August 17, 1982); and H. Con. Res. 398, which directed the enrolling clerk to make certain technical and clerical corrections to the bill. Also, where applicable, the footnotes refer to the further technical corrections to the Act made by the Technical Corrections Act of 1982 (H.R. 6056, P.L. 97-448).

[2] These bills, incorporated in H.R. 4961, dealt with the following: H.R. 2397 (treatment of lending or finance businesses for purposes of the tax on personal holding companies); H.R. 2860 (limitation on acceleration of accrual of taxes); H.R. 3262 (treatment of attorney's fees); H.R. 4408 (refunds of excise tax on buses); and H.R. 4908 (rental of residences to family members and other business uses of residences, and 2-year delay in effective date of 1976 Tax Reform Act net operating loss rules).

Black Lung Benefits Revenue Act of 1981 (subsequently enacted after approval by the House as Public Law 97-119).

- ***Ways and Means Committee hearings on the "President's Economic Proposals."***—February 18-19 and 22-24, March 30-31, April 2, 5-6 and May 5, 1982.[3]
- ***Finance Committee hearings on "Administration's Fiscal Year 1983 Budget Proposal."***—February 23-24 and March 9-12 and 16-19, 1982.[3]
- ***Finance Committee hearing on "Federal Budget Crisis."***—June 10, 1982.
- ***Finance Committee markup of H.R. 4961.***—July 1-2, 1982.
- ***H.R. 4961 reported by Finance Committee, with amendments in the nature of a substitute, "The Tax Equity and Fiscal Responsibility Act of 1982."***—July 12, 1982 (S. Rep. No. 97-494, Volumes 1 and 2). Volume 1 included the report on the spending reduction provisions (title I of the bill) and the revenue provisions (titles II and III). Volume 2 was the report on title IV of the bill (relating to airport and airway improvements).
- ***Senate floor action on H.R. 4961 as amended by the Finance Committee.***—July 19-23, 1982. Passed by the Senate, with amendments, July 23, 1982, by a record vote of 50-47.

Further House and Senate Action on H.R. 4961

- ***Senate requested a conference on H.R. 4961.***—July 28, 1982. Appointed as conferees: Senators Dole, Packwood, Roth, Danforth, Long, Harry F. Byrd, Jr., and Bentsen on the entire bill; and on title IV only (excluding sec. 406(e)), Senators Packwood, Kassebaum, and Cannon.
- ***House disagreed to Senate amendments and agreed to a conference on H.R. 4961.***—July 28, 1982. Appointed as conferees: Representatives Rostenkowski, Gibbons, Pickle, Rangel, Stark, Conable, Duncan, and Archer for the entire bill and the Senate amendments and modifications committed to conference, with the exception of subtitle B (Medicaid) of title I and title IV (Airport and Airway System Development), except for section 406(e) of that title, and with the exception of section 395 (relating to reassignment of certain VHF television licenses) of the Senate amendments and modifications committed to conference; Representatives Dingell, Waxman, Scheuer, Broyhill, and Madigan solely for the consideration of subtitle B of title I (Medicaid), subtitle C of title I (Utilization and Quality Control Peer Review), such parts of subtitle A (Medicare) of title I that related to amendments to the Supplementary Medical Insurance Program authorized under title XVIII of the Social Security Act, and section 395 of the Senate amendments and modifications committed to conference; Representatives Mineta, Anderson, Levitas, Oberstar, Clausen, Snyder, and Hammerschmidt solely for the consideration of title IV, with the exception of sections 406(e) and 407(b), of the Senate amendments and modifications committed to conference; and Representatives Fuqua,

---

[3] *Note.*—There were additional public hearings held during 1982 by the Ways and Means Committee and the Finance Committee (or by their respective Subcommittees) on topics that eventually were included in the Act, but which are not referenced in this legislative history chronology.

Glickman, and Winn solely for the consideration of section 407(b) of title IV of the Senate amendments and modifications committed to conference.

Agreed to a motion to instruct House conferees to insist that the conference report result in attainment of expenditure reduction levels no lower than those required by the conference report on the First Concurrent Resolution on the Budget for fiscal year 1983, and revenue raising levels equal to those required for fiscal year 1983 by the conference report on the First Concurrent Resolution on the Budget for fiscal year 1983, by a record vote of 299-89.

Agreed to a motion to table H. Res. 541 (to return to the Senate H.R. 4961 with the Senate amendments thereto, with the message that the Senate amendments are an infringement of the privileges of the House), by a record vote of 229-169.

Change of conferees solely for consideration of section 395 of the Senate amendment to H.R. 4961 and modifications thereof committed to conference: Representatives Dingell, Wirth, and Broyhill. (August 4, 1982).

● ***House-Senate Conference on H.R. 4961.***—August 3-5, 9-10, 12-13, and 15, 1982.

● ***Conference Report to accompany H.R. 4961, with Joint Explanatory Statement of the Committee on Conference.***—filed in the House on August 17, 1982 (H. Rep. No. 97-760); filed in the Senate on August 18, 1982 (S. Rep. No. 97-530).

● ***House Rules Committee action.***—August 18, 1982. Hearing before Rules Committee. H. Res. 569, as reported by the Rules Committee, provided a rule waiving all points of order; 4 hours of debate, 3 hours for the Ways and Means Committee and 30 minutes each for the Energy and Commerce Committee and the Public Works and Transportation Committee; and one motion to recommit, which may not contain instructions (H. Rep. No. 97-763).

● ***House action on Conference Report.***—August 19, 1982. H. Res. 569 passed the House by a record vote of 253-176; House agreed to a motion to table H. Res. 571 (to return to the Senate H.R. 4961 and Senate amendments thereto with a message that the Senate amendments and conference action contravened the Constitution, and were an infringement of the privileges of the House), by a record vote of 268-144. The conference report passed the House by a record vote of 226-207.

● ***Senate action on Conference Report.***—August 19, 1982. The Senate sustained the chair in rejecting a point of order that the conference report contained matters not germane and thus not in order by a record vote of 52-47. The conference report passed the Senate by a record vote of 52-47.

● ***Action on H. Con. Res. 398.***—August 19, 1982 House and Senate passed concurrent resolution directing the enrolling clerk to make certain technical amd clerical corrections to the bill.

● ***Enactment.***—H.R. 4961 was signed into law by President Reagan on September 3, 1982 (Public Law 97-248).

Subsequent Technical Corrections

Certain technical and clerical corrections to the Tax Equity and Fiscal Responsibility Tax Act of 1982 were enacted by section 306 of the Technical Corrections Act of 1982 (H.R 6056; Public Law 97-448).[4]

---

[4] The legislative background to the Technical Corrections Act references include, as appropriate, citations to the following: H.R. 6056 as reported by the Senate Committee on Finance (S. Rep. No. 97-592, Sept. 27, 1982); Senate floor amendments to H.R. 6056, 128 Cong. Rec. S. 12732-12739; S. Res. 489, 128 Cong. Res. S. 12888; House floor amendments to H.R. 6056, 128 Cong. Rec. H. 9600-9604; and the Conference Report to accompany H.R. 6056 (H. Rept. No. 97-986, December 21, 1982). (Further Note: H.R. 6056 as reported by the House Committee on Ways and Means and as passed by the House did not include technical corrections to TEFRA.)

II. SUMMARY OF REVENUE PROVISIONS OF THE ACT

The following is a brief summary of the principal revenue provisions of H.R. 4961, the Tax Equity and Fiscal Responsibility Act of 1982 (the "Act").[1]

A. Individual Income Tax Provisions

1. Individual minimum tax

The Act repeals the add-on minimum tax for individuals, adds several new tax preferences to the alternative minimum tax, restructures the treatment of itemized deductions in the minimum tax, establishes a flat 20-percent rate for the minimum tax, and increases the minimum tax exemption from $20,000 to $30,000 for unmarried persons and $40,000 for married couples. These changes generally apply beginning in 1983.

2. Medical expense deduction

The Act increases the floor under the itemized deduction for medical expenses from 3 percent of adjusted gross income to 5 percent, and it repeals the separate deduction for one-half of health insurance premiums up to $150, for both changes beginning in 1983. It eliminates (after 1983) the 1-percent-of-income floor on deductibility of expenditures for drugs and provides that only prescription drugs and insulin will be eligible for the deduction.

3. Casualty loss deduction

The Act limits the itemized deduction for nonbusiness casualty and theft losses to amounts in excess of 10 percent of adjusted gross income, beginning in 1983.

4. Exclusion for unemployment compensation

The Act lowers the income levels at which the exclusion for unemployment compensation begins to phase out from $20,000 to $12,000 for single returns and from $25,000 to $18,000 for joint returns, effective beginning in 1982.

B. Business Tax Provisions

1. Corporate tax preferences

The Act scales back the following corporate tax preferences by 15 percent: percentage depletion for coal and iron ore; excess bad debt reserves of financial institutions; interest incurred by financial institutions to carry tax-exempt obligations acquired after 1982; DISC; section 1250 recapture on real estate; rapid amortization of pollution control facilities; intangible drilling costs of integrated oil companies (which are to be amortized over 36 months); and mining exploration and development costs. This cutback applies only to corporations.

---

[1] For a more detailed summary of the revenue provisions of the Act, see "Summary of Revenue Provisions of H.R. 4961 (the Tax Equity and Fiscal Responsibility Act of 1982)," JCS-31-82, August 24, 1982 (for sale by the Superintendent of Documents, Government Printing Office).

2. Basis adjustment for investment tax credits

The basis of assets (which is used to compute cost recovery deductions and gain or loss) is reduced by one-half of the amount of the regular, energy, and historic structure investment tax credits.

3. Investment tax credit limitation

The percentage of tax liability which taxpayers may offset by the investment tax credit is reduced from 90 percent to 85 percent.

4. Accelerated depreciation—1985 and 1986

The Act repeals the acceleration of depreciation currently scheduled for 1985 and 1986.

5. Construction period interest and taxes

Interest and taxes attributable to the construction period for nonresidential real estate owned by a corporation must be capitalized and written off over 10 years.

6. Leasing rules

The Act repeals safe-harbor leasing after 1983. For the period between July 1, 1982, and January 1, 1984, a restricted form of safe-harbor leasing is put into effect. After 1983, a liberalized form of prior law leasing is permitted.

7. Foreign provisions

The Act provides rules under which companies with foreign oil and gas extraction income will not be able to use tax benefits from that income to reduce their taxes on other kinds of oil related income and under which oil companies will be taxed on certain oil related income of their foreign subsidiaries.

Also, the Act contains a series of rules to limit the extent to which businesses can use operations in U.S. possessions to avoid tax by transfering intangibles to their possession subsidiaries and by allowing passive income to accumulate in a possession.

8. Tax-exempt obligations

The Act provides several restrictions on industrial development bonds, including a sunset of the small issue exemption after 1986. Investments financed with IDBs will, with certain exceptions, be limited to straight-line depreciation over ACRS lives.

Also, the Act liberalizes several of the rules restricting the issuance of tax-exempt bonds for both single-family and multi-family housing.

9. Mergers and acquisitions

The Act makes a number of changes in the rules relating to partial liquidations, stock redemptions, stock purchases, and other provisions relating to mergers and acquisitions. These are designed to limit the tax benefits which now arise from mergers, acquisitions, and other corporate transactions.

10. Accounting for long-term contracts

The Act revises the rules for determining which costs are currently deductible and which must be allocated to long-term contracts. Exceptions are provided for certain construction contractors.

11. Accelerated corporate tax payments

The Act increases the percentage of current year tax liability which corporations must pay in estimated tax payments from 80 to 90 percent.

12. Original issue discount bonds

The Act eliminates certain tax benefits associated with original issue discount, including zero coupon, bonds.

13. Coupon stripping

The Act eliminates special tax treatment afforded stripping of coupons from bonds.

14. Targeted jobs credit

The Act extends the targeted jobs credit for 2 years, makes the credit available for summer employment of economically disadvantaged 16 and 17 year olds, and makes several technical and administrative changes.

C. Compliance Provisions

1. Withholding on dividends and interest

Effective July 1, 1983, the Act imposes 10 percent withholding on dividends and interest, similar to the withholding which now applies to wages. Exemptions are provided for persons 65 or older whose income (not including exempt income such as social security) is less than about $22,000 for a married couple, and there is an exemption at a lower level of income for individuals under age 65.

2. Other compliance provisions

The Act includes a number of changes designed to improve taxpayer compliance. These include additional reporting requirements, changes in penalty provisions, modifications of voluntary withholding on pensions, partnership audits, and various taxpayer safeguards.

D. Pension Provisions

The Act reduces the limits on contributions to, and benefits from, tax-qualified pension plans. The limit for annual additions under defined contribution plans is reduced from $45,475 to $30,000, and the limit on annual benefits in a defined benefit plan is reduced from $136,425 to $90,000. The indexing of these limits is suspended until 1986. Limits are placed on loans from retirement plans. Rules are provided to achieve parity between corporate and noncorporate pension plans. A $100,000 cap is placed on the estate tax exclusion for annuities. Finally, there are modifications in the rules relating to retirement plans for church employees, State judicial retirement plans, profit-sharing contributions for disabled employees, and group trusts. A nondiscrimination rule is added for employer-provided group term life insurance.

E. Insurance Provisions

The Act makes a series of changes in the tax treatment of life insurance companies and annuities. The modified coinsurance provisions of present law are repealed, and the formula for revaluing preliminary term reserves is changed. In addition, a number of provisions are adopted to reduce insurance company taxes for a 2-year period. There are also new rules relating to annuity contracts and (for 2 years) flexible premium contracts.

F. Employment Tax Provisions

1. Independent contractors

The Act provides that certain sales persons who are licensed real estate agents, and certain direct sellers, will be treated as self-employed persons, and not as employees. Also, the Act indefinitely extends the 1978 interim provisions relating to controversies as to tax classifications of workers. In addition, the Act provides for reduced employment tax liabilities in certain employment tax reclassification cases.

2. Federal unemployment tax

Beginning in 1983, the wage base subject to the Federal unemployment tax (FUTA) is increased to $7,000, the Federal tax rate is increased to 3.5 percent (raising the net Federal tax from 0.7 percent to 0.8 percent) and various changes are made in the conditions which States must meet in order for their employers to receive the maximum offset credit for State unemployment taxes. Changes are made to the definition of wages subject to the FUTA tax.

3. Medicare coverage of Federal employees

Beginning in 1983, the Act subjects Federal employees to the hospital insurance portion of the social security tax, and Federal employment will be used to determine eligibility for Medicare.

G. Excise Tax Provisions

1. Airport and airway taxes

The Act reauthorizes the Airport and Airway Trust Fund through fiscal year 1987 and reinstates (with some modifications) aviation excise taxes which were reduced in 1980, effective September 1, 1982 through December 31, 1987.

2. Cigarette excise taxes

The Act doubles the cigarette excise taxes (e.g., from 8 cents to 16 cents per pack on small cigarettes) for the period January 1, 1983, through September 30, 1985. It also imposes a floor stocks tax on cigarettes (other than certain retail stocks) held on January 1, 1983, equal to the increase in the tax rate.

3. Telephone excise tax

The Act increases the excise tax on local and long-distance telephone services from 1 percent to 3 percent for the years 1983 through 1985 and terminates the tax after 1985.

4. Windfall profit tax provisions

The Act repeals the special windfall profit tax adjustment for transportation costs applicable to Alaskan oil and clarifies the exemption for Alaskan native corporations.

5. Refund of excise tax on buses

The Act provides for additional refunds in certain circumstances relating to the 1978 repeal of the excise tax on buses.

H. Other Provisions

The bill includes additional provisions relating to the following:

a. Two-year extension of the income tax exclusion for National Research Service Awards.

b. A change permitting use of the annual accrual accounting method for certain partnerships growing sugarcane.

c. Modification of the provision disallowing deductions for certain payments to foreign government officials.

d. Authorization for the Secretary of the Treasury to vary the investment yield on savings bonds and to issue additional long-term debt.

e. Revision of the rules limiting the disclosure of tax information in nontax criminal investigations.

f. Modification of the rules under which veterans organizations may qualify for tax-exempt status.

g. Tax-exempt status for certain amateur athletic organizations.

h. Modifications of the New Jersey general revenue sharing allocation.

i. Payment of $50,000 to the Jefferson County Mental Health Center, Lakewood, Colorado, to settle claims relating to social security taxes.

j. Expansion of provisions for award of reasonable attorney fees in civil tax cases, including U.S. Tax Court cases, where the government's position was unreasonable.

k. Modification of the definition of a lending or financial business under the personal holding company provisions.

I. Revenue Effect

The revenue provisions of the Act are expected to increase fiscal year budget receipts by $18.0 billion in 1983, $37.7 billion in 1984, and $42.7 billion in 1985, for an estimated total of $98.3 billion for fiscal years 1983-1985.[2] (See tables in Part V for details of estimated revenue effects.)

---

[2] These totals do not include the change in the tax treatment of unemployment compensation (Sec. 611 of the Act), which is estimated to increase fiscal year budget receipts by $0.8 billion in 1983, $0.7 billion in 1984, and $0.6 billion in 1985.

III. GENERAL REASONS FOR REVENUE PROVISIONS

The Tax Equity and Fiscal Responsibility Act of 1982 had four principal objectives: to raise revenue as part of an effort to narrow the unacceptably large budget deficits which would have resulted from a continuation of prior spending and tax policies, to ensure that all individuals and businesses pay a fair share of the tax burden, to reduce the distortions in economic behavior that resulted from the tax system, and to increase the extent to which those responsible for specific Federal Government spending pay the costs of that spending. Congress believed that this Act made a major contribution to each of these goals.

Revenue needs

Early in 1982, it became clear that, in the light of the recession, high interest rates and the decline in inflation, continuing present spending and tax policies would have resulted in unacceptably large federal budget deficits. Projections by the Office of Management and Budget and the Congressional Budget Office indicated that federal deficits, if policy did not change, could reach $182 billion in fiscal year 1983, $216 billion in 1984 and $233 billion in 1985. By 1985, at a time when the economy was expected to be prosperous, the Federal deficit was projected to be 5.6 percent of gross national product—the largest deficit in peacetime history.

Such deficits would have had serious consequences. First, a stimulative fiscal policy, in conjunction with the restrictive monetary policy with which the Federal Reserve was attempting to control inflation,. could have led to continued very high interest rates. These interest rates would have reduced business investment, made it difficult for all but the most affluent Americans to acquire their own homes, and caused the bankruptcy of many businesses, both large and small.

Second, large deficits and high interest rates would have greatly increased the costs of servicing what would have become a crushing burden of the national debt. Outlays for net interest on the debt had already grown from $52.5 billion in fiscal year 1980 to an estimated $86.0 billion in 1982, or from 2.0 to 2.8 percent of GNP. The current policy budget projections of OMB and the CBO were that this debt service burden would grow to $147.1 billion in 1985, or to 3.6 percent of GNP.

Third, large deficits could have put pressure on the Federal Reserve either to pursue very tight monetary policies or to accommodate the deficits with a monetary expansion that could rekindle double-digit inflation. Fiscal restraint will permit the burden of fighting inflation to be spread more evenly throughout the economy.

Fourth, large deficits would have implied a lack of control by Congress over government operations and fiscal policy, which would have caused uncertainty among those making financial and investment decisions.

The first congressional budget resolution for fiscal year 1983 contained an integrated set of spending and tax policies designed to bring these deficits under control. The resolution provided for revenue increases of $20.9 billion in fiscal year 1983, $36.0 billion in 1984 and $41.4 billion in 1985, a total of $98.3 billion over the three-year period. The Act raises enough revenue to match the three-year budget target.

It should be noted that these revenue increases are modest in relation to the tax reductions enacted in the Economic Recovery Tax Act of 1981. That Act provided tax reductions, broadly distributed among individuals and businesses, of approximately $88 billion in fiscal year 1983, $140 billion in 1984, and $190 billion in 1985. Thus, the targeted revenue increases provided for in the budget resolution and the Act are only about one-fourth the size of last year's tax cuts.

Tax equity

A widely accepted goal of tax policy is that the tax burden be distributed fairly, in accordance with people's ability to pay. This is particularly important in the United States, where tax collection relies heavily on voluntary compliance. Several studies show that taxpayers are more likely to comply voluntarily with the tax laws if they believe that similarly situated taxpayers are bearing a comparable share of the tax burden.

Unfortunately, over the past several years, the trend had been toward less equity. Dozens of special deductions, exclusions and tax credits have been enacted, and while these generally have served worthwhile purposes, their cumulative effect has been to make the system less equitable and more complex. The Act attempts to reverse this trend by scaling back or repealing those tax preferences which are no longer needed or which can no longer be justified in light of the present budgetary situation.

A blatant inequity occurs when some people take advantage of our voluntary compliance system to evade the tax laws. Statistics prepared by the Internal Revenue Service indicate that noncompliance with the tax laws is growing, and it is becoming an extremely serious national problem. Congress believed that it would be unfair to ask the majority of honest Americans to pay more taxes unless every reasonable effort was being made to make sure that tax evaders comply with the law. The cuts in marginal tax rates enacted last year, and the provisions of the Act which create a more equitable distribution of the tax burden, will contribute to improved compliance. However, Congress believed that more direct action was needed to deal with this urgent national problem, and the Act contains provisions to improve both the withholding and information reporting systems.

A key goal of Congress was to achieve the revenue targets in the budget resolution through tax changes which improved tax equity, rather than to achieve them through broadly based tax increases, such as increases in marginal individual income tax rates or taxes on energy consumption.

Economic distortions

In recent years, there has been considerable discussion and analysis of the various ways in which the tax system distorts economic behavior in the private sector and the impact of such distortions on economic growth. Much of this discussion has focused on how these distortions might be alleviated by tax reductions, and the 1981 tax reduction was a major step toward this goal. However, it is also possible for economic distortions to result from overly generous tax incentives. Congress reviewed existing tax incentives with this in mind and decided to scale back several of those which increased, rather than reduced, economic distortions.

One example of excessive incentives was the combination of accelerated depreciation and the investment tax credit which, in many cases, provided tax benefits more generous than deducting the cost of equipment in the year it was placed in service (expensing). Such treatment could have encouraged businesses to purchase equipment which would not have been profitable on a pre-tax basis. The basis adjustment for one-half of the investment tax credit in the Act should reduce the combined benefits of depreciation and the credit to the point where they are approximately equivalent to expensing under conditions presently prevailing in the economy.

Other examples of tax provisions which created economic distortions, and which the Act repeals or modifies, include the tax treatment of original issue discount bonds, the tax treatment of mergers and acquisitions, the tax treatment of the insurance industry, safe-harbor leasing, and the completed contract method of accounting. In each of these areas, the Act both raises revenues and improves economic efficiency.

Allocation of the costs of government

A recurring issue for a democratic society is determining the appropriate level of government services. One way to deal with this problem is to raise revenues through user taxes in cases where public spending is clearly allocable to specific beneficiaries, so that those responsible for government spending pay for that spending. For example, 80 percent of Federal retirees age 65 or over receive Medicare, even though they make contributions during only part of their careers; the typical private sector worker makes contributions over his entire career. Thus, the Act subjects Federal employees to the Medicare portion of the social security tax. Similarly, unemployment benefits are supposed to be financed by a payroll tax on employers, but tax revenues have been insufficient so that the unemployment benefit system has had to borrow substantial revenues from the Treasury, that is, from general taxpayers. Therefore, the Act increases both Federal and State unemployment taxes. Likewise, the taxes applying to aviation users are also increased to ensure that the users, rather than all taxpayers, pay for a greater share of the expenses of developing and operating the airport and airway control systems. Twelve percent of the revenue raised by the Act comes from these provisions aimed at those responsible for specific government spending.

IV. GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE ACT

A. Individual Income Tax Provisions

1. Alternative minimum tax (sec. 201 of the Act and secs. 55–58 of the Code)*

Prior Law

Add-on minimum tax

Under prior law, individuals paid an add-on minimum tax on certain tax preferences. This tax was in addition to the individual's regular tax. The amount of the minimum tax was 15 percent of the individual's tax preferences in excess of the greater of one-half of the regular income tax paid or $10,000.

The tax preference items included in the minimum tax base were:

(1) Accelerated depreciation on real property in excess of straight-line depreciation over the useful life or recovery period (in the case of property eligible for ACRS, 15 years);

(2) Accelerated depreciation on personal property subject to a lease;

(3) Amortization of certified pollution control facilities (the excess of 60-month amortization over depreciation otherwise allowable);

(4) Percentage depletion in excess of the adjusted basis of the property;

(5) Amortization of child care facilities (the excess of 60-month amortization over depreciation otherwise allowable); [1] and

(6) Intangible drilling costs on oil, gas and geothermal wells in excess of the amount amortizable with respect to the cost, and in excess of net income from oil, gas and geothermal production.

In computing the amount of the regular tax deduction from the minimum tax base, the regular tax liability was reduced by nonrefundable credits. Credits (other than refundable credits) were not allowed against the individual minimum tax.

Alternative minimum tax

Individuals also were subject to an alternative minimum tax which was payable to the extent it exceeded the individual's regular tax owed.[2] The alternative minimum tax was computed using alternative minimum taxable income, which was the taxpayer's taxable income increased by (1) the deduction for long-term capital gains, and (2) the amount of the taxpayer's adjusted itemized deductions. The tax rate was 10 percent of the alternative minimum taxable income from $20,000 to $60,000 and 20 percent of the amount in excess of $60,000. Tax credits, other than the foreign tax credit, generally were allowable against this tax only if attributable to an active trade or business and only to the extent the tax was not attributable to net capital gains or to adjusted itemized deductions. Any credit disallowed by this rule increased the amount allowed as a credit carryover.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 201; S. Rep. No. 97–494, Vol. 1 (July 12, 1982), pp. 107–112; Senate floor amendments, 128 Cong. Rec. S8952–8960, S8987–8988, S9016 (July 22, 1982); and H. Rep. No. 97–760 (August 17, 1982), pp. 473–476 (Joint Explanatory Statement of the Committee of Conference).

[1] The rapid amortization of child care facilities terminated for expenditures made after 1981.

The foreign tax credit was allowed in full against the alternative minimum tax. In general, the regular foreign tax credit rules applied, but the foreign tax credit limitation was computed separately with respect to the alternative minimum tax. Thus, the amount of foreign tax that could be credited against the alternative tax was limited to the same proportion of the gross alternative tax as the taxpayer's alternative minimum taxable income from sources without the United States bore to his entire alternative minimum taxable income. The taxpayer was then required to pay an amount equal to the greater of the after-credit regular tax or the after-credit alternative minimum tax. A special rule was also provided for computing the amount of unused foreign taxes that could be carried back or carried forward.

Generally, an individual's preference for adjusted itemized deductions was the amount of a taxpayer's itemized deductions (other than the deductions for medical expenses, casualty losses, and state, local and foreign taxes) in excess of 60 percent of adjusted gross income (as reduced by the itemized deductions just listed). In the case of estates and trusts, certain additional adjustments were made.

Reasons for Change

Congress amended the present minimum tax provisions applying to individuals with one overriding objective: no taxpayer with substantial economic income should be able to avoid all tax liability by using exclusions, deductions and credits. Although these provisions provide incentives for worthy goals, they become counterproductive when individuals are allowed to use them to avoid virtually all tax liability. The ability of high-income individuals to pay little or no tax undermines respect for the entire tax system and, thus, for the incentive provisions themselves. Therefore, Congress provided an alternative minimum tax which was intended to insure that, when an individual's ability to pay taxes is measured by a broad-based concept of income, a measure which can be reduced by only a few of the incentive provisions, tax liability is at least a minimum percentage of that broad measure. The only deductions allowed, other than costs of producing income, are for important personal or unavoidable expenditures (housing interest, medical expenses and casualty losses) or for charitable contributions, the deduction of which already is limited to a percentage of adjusted gross income.

---

[2] A taxpayer's regular tax means the taxes imposed by chapter 1 of the Code (other than the alternative minimum tax and the penalty taxes applicable in certain circumstances for annuities (sec. 72(m)(5)(B), lump-sum distributions from qualified pension plans (sec. 402(e)) and individual retirement accounts (sec. 408(f) and 409(c))), reduced by all nonrefundable credits including the foreign tax credit (sec. 33).

The changes in the minimum tax also simplify the taxpayer's computations, since the present law add-on minimum tax is repealed. This change actually provides tax reductions for many middle-income taxpayers who pay a minimum tax on some preference income but also have substantial amounts of non-preference income. By adding all preferences into the base of the alternative minimum tax and focusing the minimum tax on high income individuals, the provision increases tax liability only for income classes of taxpayers with over $50,000 of income.

Explanation of Provision

Overview

The Act repeals the present law "add-on" minimum tax for individuals beginning in 1983 and expands the alternative minimum tax.

Generally, the tax base for the alternative minimum tax is an individual's adjusted gross income (without regard to the net operating loss deduction, but using a negative amount where the taxpayer's other "above-the-line" deductions exceed gross income) plus the taxpayer's tax preferences for the year, reduced by certain itemized deductions and a minimum tax net operating loss deduction. The resulting amount, called alternative minimum taxable income, then is reduced by a $30,000 exemption ($40,000 in the case of married taxpayers filing a joint return or a surviving spouse; $20,000 in the case of a married individual filing a separate return or a trust or estate) and is subject to tax at a 20-percent rate. The taxpayer then may use the foreign tax credit and the refundable credits to offset this tax.

The amount of minimum tax is the amount by which the tax computed under this rate schedule exceeds the taxpayer's regular tax. It was not intended that the regular tax, for this purpose, include any amount attributable to recapture of a prior year's investment credit; a technical correction is necessary to achieve this result. Although the tax is, in effect, a true alternative tax, in the sense that it is paid only when the amount of tax computed under the above schedule exceeds regular tax, technically the taxpayer's regular tax continues to be imposed, and the amount of alternative minimum tax is the *excess* of the amount computed under the minimum tax over the amount of the regular tax.

Preferences

In general, the preferences for purposes of the alternative minimum tax are the same as the preferences under prior law for the add-on minimum tax, except that the preference for amortization of child care facilities is deleted. Also, the preference for capital gains remains subject to the alternative minimum tax, but the adjusted itemized deductions preference is repealed.

In addition, the Act adds several new minimum tax preferences for individuals. Certain expenditures which the taxpayer expenses, in excess of the amount which would have been allowable for the taxable year if the expenditures had been capitalized and amortized on a straight-line basis over a 10-year period (beginning with the year in which the expenditures are incurred), are made items of tax preference. These include expenditures for mining exploration costs (under sec. 617), development expenditures (under sec. 616), circulation expenditures (under sec. 173), and research and experimental expenditures (under sec. 174). Interest excluded under the all-savers and net interest exclusions (sec. 128) and dividends excluded under the dividend exclusion (sec. 116) are also items of tax preference. Furthermore, a preference is added for the excess of the fair market value of stock received upon the exercise of an incentive stock option over the exercise price. It was not intended that the incentive stock option preference apply, however, where the special tax treatment for incentive stock options does not apply because there is an early disposition, as specified in section 422A(a)(1), of the stock acquired through the exercise of the option.

Minimum tax itemized deductions

In computing the minimum tax base, certain itemized deductions allowable under the regular tax will be allowed. These include the deductions for casualty losses and wagering losses (sec. 165(c)(3) and (d)), charitable contributions (sec. 170), the estate tax (sec. 691(c)), housing interest, and other interest to the extent of net investment income included in the minimum tax base. In addition, the deduction for medical expenses (sec. 213) is allowed but only to the extent they exceed 10 percent of the taxpayer's adjusted gross income. Deductions which are carried over under the regular tax, such as disallowed investment interest (Sec. 163(d)), are not allowable in computing the minimum tax base.

Housing interest includes interest on debt incurred in acquiring, constructing, or substantially rehabilitating a dwelling which is used by the taxpayer or a member of his family and which is a house, apartment, condominium, or mobile home not used on a transient basis, or which is the taxpayer's principal residence. If the taxpayer refinances a loan used to acquire, construct, or substantially rehabilitate the dwelling or residence and the principal amount of the new loan is less than or equal to what the principal amount of the old loan was immediately before the refinancing, then all of the interest on the new loan is housing interest. The same treatment applies if any increase in debt is used for acquiring, constructing or substantially rehabilitating an eligible dwelling or residence. However, if the principal amount on the new loan exceeds that of the old loan and the excess is not applied to these housing uses, then only a fraction of the interest on the new loan is housing interest. The fraction that is housing interest is equal to the ratio of the principal amount of the old loan (immediately before the refinancing) to the principal amount of the new loan. The Secretary may prescribe by regulation a similar rule for a taxpayer who sells an old house and buys a new house, in a case where Code section 1034 (rollover of gain on sale of principal residence) applies. A transition rule provides that housing interest also includes interest on debt incurred before July 1, 1982, which was secured before that date by a dwelling unit of the type listed above or by a principal residence, whether or not the proceeds of the debt were used to purchase the taxpayer's housing.

Interest, other than housing interest, is deductible only to the extent of net investment income. Net investment income means the excess of qualified investment income over the deductions directly connected with the production of that income to the extent that those deductions (including any deduction for interest) are "above-the-line" deductions (i.e., deductions in arriving at adjusted gross income) and are not items of tax preference. Qualified investment income generally means interest, dividends, rents, royalties and net gain from the disposition of property held for investment to the extent that the items are not derived from the conduct of a trade or business. The special rules under section 163(d) which treat property subject to a net lease as investment property (rather than trade or business property) and which provide for the allocation of income and expense items of a partnership or subchapter S corporation among partners and subchapter S corporation shareholders are to be applicable for purposes of computing net investment income under this provision of the minimum tax.

Generally, the only interest subject to the net investment income limitation is interest which is not deductible in arriving at adjusted gross income under the regular tax and is not housing interest. However, interest on indebtedness incurred to acquire or carry a limited partnership interest or an interest in a subchapter S corporation (in the case of a person who does not actively participate in the management of the corporation) is "below-the-line" interest for purposes of the minimum tax and therefore is subject to the net investment income limitation on the interest deduction. Further, net income or loss taken into account, directly or indirectly, from such an interest will be considered net investment income for the purposes of the net investment income limitation on the interest deduction.

Thus, for example, assume a taxpayer had $100,000 of dividend income and also held a limited partnership interest in a partnership all of whose income is derived from a trade or business. The taxpayer's distributive share of partnership income included $200,000 of gross income and $300,000 of deductions which are not preferences (including partnership deductions for business interest). Because the partnership items are treated as items of investment income and investment expense to the limited partner for purposes of computing net investment income, the taxpayer would have no net investment income for the taxable year ($300,000 gross investment income less $300,000 investment expenses) and, therefore, could deduct no "below the line" interest (other than eligible housing interest), including interest on debt used to purchase or carry the limited partnership interest.

Credits

A taxpayer paying the alternative minimum tax is not to obtain the benefit of nonrefundable credits other than the foreign tax credit, which is allowed to the extent of the minimum tax on the taxpayer's foreign-source alternative minimum taxable income. However, as under prior law, the Act provides that credit carrybacks or carryovers to other years from a year in which the taxpayer is liable for some amount of alternative minimum tax are not to be reduced to the extent of the taxpayer's alternative minimum tax liability. For example, if a taxpayer has a regular tax liability before credits of $10,000, investment tax credits of $5,000, and alternative minimum tax before regular tax offset of $8,000, the taxpayer will pay a tax of $8,000 (consisting of regular tax of $5,000 and alternative minimum tax of $3,000). In this case, the taxpayer has used up all $5,000 of investment tax credits against regular tax but has received a benefit only from $2,000 ($10,000 minus $8,000) of credits. Thus, if the credit would not otherwise expire,[3] the remaining $3,000 of credit for which no tax reduction was obtained is to be available as an additional carryover to the next year to which the credit would be carried over under the usual credit carryover rules.

The foreign tax credit and refundable credits are allowable against the alternative minimum tax in accordance with the rules of prior law.

Net operating losses

The provision adopts special rules for net operating losses. For purposes of the alternative minimum tax, net operating loss deductions will be determined by using a separate computation of minimum tax net operating losses and loss carryovers. Generally, this computation will take into account the differences between the regular tax base and the minimum tax base.

The amount of the net operating loss (under sec. 172(c)) for any taxable year, for purposes of the minimum tax, generally will be computed in the same manner as the regular net operating loss with two exceptions. First, the items of tax preference arising in that year are added back to taxable income, and, second, only those itemized deductions (as modified under sec. 172(d)) allowable in computing alternative minimum taxable income are taken into account. In computing the amount of deduction for years other than the year of the loss (i.e., carryover years), the recomputed loss is deducted from the alternative minimum taxable income (as modified under sec. 172(b)(2)(A)) in the carryover year (whether or not the taxpayer is subject to the minimum tax that year). A transitional rule allows, for purposes of the minimum tax, all pre-effective date regular tax net operating losses to be carried forward as minimum tax NOLs to the first taxable year for which the new minimum tax applies (and to subsequent years until used up). The pre-effective date losses will continue to be subject to the add-on minimum tax, as under prior law (sec. 56(b)).

For example, if in year one a taxpayer has $20,000 of income and $35,000 of losses, of which $10,000 are preference items, the minimum tax net operating loss for the year is $5,000. Thus, in any subsequent (or prior) year to which the loss can be carried, a $5,000 net operating loss deduction will be allowed to reduce income subject to the alternative minimum tax.

---

[3] Where the amount of credits allowed under the regular tax from which no benefit is obtained involves more than one tax credit, the additional credit allowed as a carryback or carryover is first to be allocated to the credit which is taken last under the normal Code rules. Thus, any additional credit is first allocated to the research and experimental credit, then to the alcohol fuels credit, the residential energy credit, the targeted jobs credit, the WIN credit (to the extent of carryovers used) and finally to the investment tax credit.

Assume that in year two, the taxpayer has $20,000 of minimum taxable income (without regard to the net operating loss deduction). The taxpayer will be allowed to reduce his minimum taxable income to $15,000 by the $5,000 net operating loss deduction. The net operating loss deduction for purposes of the regular tax will not be affected by this computation (i.e., the taxpayer will have a loss carryover of $15,000 from year one to be used under the regular tax).

Trusts and estates

The provision also contains certain conforming rules relating to the application of the alternative minimum tax to trusts and estates. A trust or estate is to be allowed as itemized deductions (in addition to those allowed to an individual) the charitable deduction under section 642(c) and the distribution deductions under sections 651(a) and 661(a). Costs paid or incurred in connection with the administration of the estate or trust are to be treated as deductions allowed in computing adjusted gross income. Also, as under prior law, items of tax preference are to be allocated between the trust or estate and the beneficiaries in accordance with regulations, and accumulation distributions are not included in the minimum tax base.

Election to amortize certain tax preferences

An election is provided for individuals to amortize mining exploration and development costs, circulation expenditures, research and experimental expenditures, and intangible drilling costs, for purposes of the regular tax and minimum tax, over a 10-year period beginning with the year the expenditure occurs. Individuals will not have a preference from these costs to the extent that they elect 10-year amortization. This election may be made for any portion of costs that the taxpayer selects.

The Act also provides that instead of being amortized over 10 years, all or a part of the amounts otherwise deductible as intangible drilling costs (IDCs) may be treated as if such amounts were used to acquire recovery property assigned to the 5-year class. ACRS deductions are allowed beginning with the year the expenses are paid or incurred and the investment tax credit is available in the year the property is placed in service. The investment tax credit basis adjustment provisions (sec. 48(q)), including the election to claim a reduced credit, are to apply. If property to which the IDCs are allocable is disposed of, the deduction will be subject to recapture (under sec. 1254) and the credit will be subject to recapture (under sec. 47) in accordance with the usual recapture rules. This election to treat part or all of IDCs as 5-year recovery property is not available with respect to interests in which the taxpayer is a limited partner. This election was not intended to be available with respect to IDCs incurred outside the United States, and a technical correction may be necessary to clarify this point. Amounts capitalized and expensed under the ACRS schedule will not be an item of tax preference.

In the case of a partnership, each partner may elect separately the portion of the expenses to be capitalized and treated under the rules applicable to that partner's interest.

Effective Date

The provision applies to taxable years beginning after December 31, 1982.

Preferences arising under present law in pre-1983 years and creating net operating loss carryforwards to post-1982 years will continue to be subject to the add-on minimum tax to the extent provided in prior law under section 56(b).

Revenue Effect

These changes are expected to increase fiscal year receipts by $659 million in 1984, $701 million in 1985, $741 million in 1986 and $729 million in 1987.

2. Limitation on deduction for medical expenses (sec. 202 of the Act and sec. 213 of the Code)[*]

Prior Law

Individuals who itemized deductions were able to deduct two categories of medical expenses. First, a deduction of up to $150 was allowed for one-half of health insurance premiums. Second, a deduction was allowed for all other unreimbursed medical expenditures, including health insurance premiums not allowed in the first category, to the extent that these expenses exceeded 3 percent of adjusted gross income. Drug and medicine expenditures could be included in the second category only to the extent the total of these expenditures exceeded 1 percent of adjusted gross income.

Reasons for Change

The primary rationale for allowing an itemized deduction for medical expenses is that "extraordinary" medical costs—those in excess of a floor designed to exclude predictable, recurring expenses—reflect an economic hardship, beyond the individual's control, which reduces the ability to pay Federal income tax. In recent years, however, because medical costs have risen faster than incomes and because of the broad coverage of expenses (such as capital expenses and transportation expenses), an increasing number of individuals have claimed deductions for expenses in excess of the floor of 3 percent of adjusted gross income. As a result, a larger number of individuals have, in effect, received partial reimbursement for their medical expenses, thereby creating an incentive for further health care spending and exacerbating the problem of rising medical care expenditures. Further, many of the expenses which are small relative to income do not significantly reduce ability to pay taxes, especially since they could have been avoided by the purchase of insurance. Finally, the medical expense deduction is complex, since detailed records must be kept and difficult distinctions must be made between expenses for medical treatment (deductible) and expenses for ordinary consumption (nondeductible). For these reasons, Congress decided to limit the use of the medical expense deduction by raising the floor from 3 to 5 percent of adjusted gross income.

Further, the separate deduction for health insurance premiums and the separate 1-percent floor for drugs complicated the computation of the deduction, and Congress decided to eliminate them. Finally, Congress eliminated the deduction for non-prescription drugs other than insulin to simplify the deduction, to conform its coverage more closely to the coverage of private health insurance policies, and because expenses for non-prescription drugs are more likely to represent expenses for ordinary consumption than "extraordinary" medical costs that should be deductible.

---

[*] For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 202; S. Rep. No. 97–494, Vol. 1 (July 12, 1982), pp. 113–114; Committee amendment, 128 Cong. Rec. S8642–44 (July 19, 1982); and H. Rep. No. 97–760 (August 17, 1982), p. 476 (Joint Explanatory Statement of the Committee of Conference).

Explanation of Provision

The Act makes three changes in the medical expense deduction. First, the separate $150 deduction for one-half of health insurance premiums is eliminated (health insurance premiums continue to be counted as medical expenses that may be deducted subject to the adjusted gross income floor). Second, the floor for deductible medical expenses is raised from 3 to 5 percent of adjusted gross income. Third, the 1-percent floor under drug expenditures is eliminated, and the only drug expenditures which will be deductible will be expenditures for drugs which legally require a prescription or for insulin.

Effective Date

The elimination of the health insurance premium deduction and the increase in the floor for deductible medical expenses are effective for taxable years beginning after December 31, 1982. The elimination of the deduction for non-prescription drug expenditures and the elimination of the separate 1-percent floor are effective for taxable years beginning after December 31, 1983.

Revenue Effect

It is estimated that this provision will increase fiscal year budget receipts by $272 million in 1983, $1,788 million in 1984, $1,671 million in 1985, $1,795 million in 1986, and $1,947 million in 1987.

3. Limitation on deduction for non-business casualty losses (sec. 203 of the Act and sec. 165 of the Code)[*]

Prior Law

Individuals who itemize deductions may deduct unreimbursed losses of nonbusiness, noninvestment property resulting from fire, storm, shipwreck, or other casualty, or from theft. For tax purposes, the amount of the loss is considered to be the lower of (1) the fair market value of the property immediately before the casualty, reduced by the fair market value of the property immediately after the casualty (zero in the case of a theft), or (2) the property's adjusted basis. For any one casualty, the deduction is allowed only to the extent that the amount of the loss exceeds $100. Under prior law, the remainder of all losses was deductible in full.

Reasons for Change

The itemized deduction for personal casualty losses created significant problems of complexity, recordkeeping, and audit for both individuals and the Internal Revenue Service. Arbitrary lines must be drawn between deductible expenditures for sudden casualty losses and nondeductible expenses for losses caused by gradual deterioration. Taxpayers must be prepared to document and defend estimates of fair market value of lost and damaged property for purposes of the deduction. As a result of this complexity, under prior law, a very high percentage (about 35 percent, according to Internal Revenue Service estimates) of amounts claimed as deductions were not properly deductible.

In addition, Congress was aware that the casualty loss floor had not been raised from $100 since 1964, despite the inflation of recent years. Furthermore, Congress was concerned with the fact that the deduction offset a higher percentage of losses for high-bracket than for low-bracket taxpayers, even though the latter are less able to purchase insurance to avoid losses and also are more likely to need assistance in coping with expenses. In addition, Congress believed that the $100 floor was not an appropriate way to identify extraordinary casualty losses that should be taken into account by the tax system because of their impact on an individual's ability to pay taxes.

In order to reduce the number of users of this complex deduction and the partial reimbursement of losses provided by the tax system, while maintaining the deduction for losses which significantly affect an individual's ability to pay taxes, Congress decided to put a percentage-of-adjusted-gross-income floor under the casualty loss deduction similar to the floor under the medical expense deduction. A floor of this type is fair to taxpayers of all income levels because the size of a loss that significantly reduces an individual's ability to pay tax varies with his income.

---

[*] For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 203; S. Rep. No. 97–494, Vol. 1 (July 12, 1982), pp. 115–116; Senate floor amendment, 128 Cong. Rec. S9016 (July 22, 1982); and H. Rep. No. 97–760 (August 17, 1982), pp. 476–477 (Joint Explanatory Statement of the Committee of Conference).

Explanation of Provision

The Act provides that the deduction for casualty and theft losses is allowed only to the extent that the total amount of such losses sustained during the taxable year exceeds 10 percent of the taxpayer's adjusted gross income. As under prior law, a casualty or theft loss is taken into account only to the extent that the loss exceeds $100 for any occurrence. Individuals who elect to take into account a nonbusiness disaster loss for the taxable year prior to the taxable year in which the disaster occurred must use the adjusted gross income of the prior taxable year in determining the extent to which the loss is deductible.

Effective Date

The amendments made by the Act generally apply to taxable years beginning after December 31, 1982. However, the amendments also apply to the taxpayer's last taxable year beginning before January 1, 1983, for a taxpayer who elects to take into account a disaster loss in such a taxable year. For example, if a calendar year taxpayer experiences a disaster loss in 1983 and elects to claim the loss for calendar year 1982, the loss is deductible only to the extent it exceeds 10 percent of the taxpayer's 1982 adjusted gross income.

Revenue Effect

It is estimated that the provision will increase fiscal year budget receipts by $666 million in 1984, $734 million in 1985, $800 million in 1986, and $880 million in 1987.

4. Taxation of unemployment compensation (sec. 611 of the Act and sec. 85 of the Code)*

Prior Law

All or a portion of unemployment compensation benefits paid pursuant to government programs may be included in the recipient's gross income. The amount of unemployment compensation that is included in adjusted gross income generally is limited to one-half of the excess of (1) the sum of the taxpayer's adjusted gross income, all unemployment compensation paid pursuant to government programs, all disability income of the type eligible for exclusion from income (under Code sec. 105(d)), and the amount allowed under the deduction for two-earner married couples over (2) the taxpayer's base amount.

The base amount was $25,000 in the case of a married individual filing a joint return; zero in the case of a married individual filing a separate return (unless he or she lived apart from his or her spouse for the entire taxable year); and $20,000 in the case of all other individuals.

An individual may be subject to an estimated tax penalty to the extent that estimated tax payments and withholding for a taxable year are less that 80 percent of actual tax liability for that year.

Reasons for Change

In order to increase cumulative revenues during fiscal years 1983 to 1985 by an amount approximately equal to the increased outlays resulting from the Act's provision of additional unemployment benefits (secs. 602–606), the Act lowers the income thresholds which determine the amount of unemployment compensation includible in adjusted gross income. By extending the duration of unemployment benefits for those who cannot find work, while simultaneously increasing the taxation of benefits for those who have substantial amounts of other income during the year, the Act improves the targeting of available resources to those who are most in need.

Explanation of Provision

The Act reduces the base amounts for purposes of computing the amount of unemployment compensation included in adjusted gross income from $20,000 to $12,000 for single taxpayers and from $25,000 to $18,000 for married taxpayers filing joint returns. The base amount remains zero for married taxpayers who file separately.

---

*For legislative background of the provision, see: H. Rep. No. 97–760 (August 17, 1982), p. 461 (Joint Explanatory Statement of the Committee of Conference).

Effective Date

General rule.—The provision applies to payments of unemployment compensation made after December 31, 1981, in taxable years ending after that date.

Special rule for underpayment of estimated tax.—An individual is not to be penalized for an underpayment of estimated tax to the extent that the underpayment is attributable to the inclusion in income of unemployment compensation received during 1982 that, but for the provision lowering the base amounts, was not includible in income.

Special rule for fiscal year taxpayers.—A fiscal year taxpayer whose taxable year includes January 1, 1982, takes into account the entire amount of unemployment compensation received during the fiscal year for purposes of determining how much to include in income. However, the increase in adjusted gross income for that fiscal year which can occur as a result of this section of the Act is limited to the amount of unemployment compensation paid after December 31, 1981.

Revenue Effect

The provision will increase fiscal year receipts by $763 million in 1983, $734 million in 1984, $611 million in 1985, $618 million in 1986, and $650 million in 1987.

B. Business Tax Provisions

1. Corporate tax preferences (sec. 204 of the Act and new sec. 291 of the Code)*

Prior Law

Under prior law, corporations paid a minimum tax on certain tax preferences. The tax was in addition to the corporation's regular tax. The amount of the minimum tax was 15 percent of the corporation's tax preferences in excess of the greater of the regular income tax paid or $10,000.

The tax preference items included in this base of the minimum tax for corporations were:

(1) Accelerated depreciation on real property in excess of straight-line depreciation over the useful life or recovery period (in the case of property eligible for ACRS, 15 years);

(2) Amortization of certified pollution control facilities (the excess of 60-month amortization over depreciation otherwise allowable);

(3) In the case of certain financial institutions, the excess of the bad debt deductions over the amount of those deductions computed on the basis of actual experience;

(4) Percentage depletion in excess of the adjusted basis of the property;

(5) $^{18}/_{46}$ of the corporation's net capital gain; [1] and

(6) Amortization of child care facilities (the excess of 60-month amortization over depreciation otherwise allowable).[2]

In computing the amount of the regular tax deduction from the corporation's minimum tax base, the corporation's regular tax liability was reduced by nonrefundable credits other than the credits relating to ESOPs. Credits (other than refundable credits) were not allowed against the corporate minimum tax.

Reasons for Change

Numerous corporate tax preferences have been enacted over the years in order to stimulate business investment and advance other worthwhile purposes. For several reasons, Congress believed that some of these tax preferences should be scaled back. First, the Federal budget faced large deficits, which will require large reductions in direct Federal spending. In addressing these deficits, Congress believed that tax preferences should also be subject to careful scrutiny. Second, in 1981 Congress enacted the Accelerated Cost Recovery System, which provided very generous incentives for investment in plant and equipment. ACRS makes some corporate tax preferences less necessary. Third, there was increasing concern about the equity of the tax system, and cutting back corporate tax preferences was a valid response to that concern.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 206; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 118-121; Senate floor amendments, 128 Cong. Rec. S8898 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 478-481 (Joint Explanatory Statement of the Committee of Conference).

[1] Special rules applicable to capital gains from timber have the effect of reducing the tax rate to 10 percent, increasing the exemption to $30,000, and allowing a regular tax carryover.

[2] The rapid amortization for child care facilities terminated for expenditures made after 1981.

For these reasons, the Act contains a 15-percent cutback in certain corporate tax preferences.

Explanation of Provisions

Overview

The Act provides for a 15-percent cutback in certain corporate tax preferences. Generally, the cutback applies to preferences not otherwise dealt with in the Act. Adjustments are made to the corporate minimum tax to prevent the combination of that tax and this provision from unduly reducing the tax benefit from a preference. The changes apply only to corporations other than subchapter S corporations.

Depletion for coal and iron ore

The excess of percentage depletion otherwise allowable for iron ore and coal (including lignite) over the adjusted basis of the property is reduced by 15 percent. However, only 71.6 percent [3] of the excess of the allowable depletion allowances for these minerals over the adjusted basis of the property will be treated as a corporate tax preference under the minimum tax (under section 57(a)(8)).

Bad debt reserves

The bad debt reserve deduction (under sec. 585 or 593) will be reduced by 15 percent of the amount by which the otherwise allowable deduction exceeds the amount which would have been allowable on the basis of actual experience. Only 71.6 percent of the excess of the allowable deduction over what would be allowable based on actual experience will then be treated as an item of tax preference under the minimum tax (under sec. 57(a)(7)).

---

[3] The 71.6 percent figure is what is needed to prevent the combination of the add-on minimum tax and the 15-percent preference cutback from reducing the tax benefit from the taxpayer's marginal dollar of preference by more than it is currently cut back by the minimum tax for a taxpayer who has a 46-percent marginal regular tax rate, paid more than $10,000 of regular tax and had tax preferences in excess of regular tax liability.

Consider, for example, a taxpayer with $100 of percentage depletion. He received a regular tax benefit of $46 from the preference under prior law. However, the preference led to a direct minimum tax of $15 (the 15-percent minimum tax rate times the $100 preference), as well as an indirect minimum tax of $6.90 through the reduction in the deduction for regular taxes under the minimum tax ($46 times 15 percent). Thus, the net tax benefit from the preference, at the margin, was $24.10.

Under the Act's preference cutback, the depletion deduction is reduced to $85, reducing its regular tax benefit to $39.10 (46 percent times $85). Including only 71.6 percent of the preference ($60.86) in the minimum tax reduces the direct minimum tax to $9.13 (15 percent times $60.86). Together with the indirect minimum tax through the reduction in the deduction for regular taxes (15 percent times $39.10, or $5.87), this reduces the total tax benefit from the preference to $24.10 ($39.10 minus $9.13 minus $5.87). Thus, the tax benefit from this taxpayer's marginal dollar of percentage depletion will be the same as under prior law.

Tax-exempt interest

In the case of a financial institution, 15 percent of the otherwise allowable interest deduction allocable to debt incurred or continued to purchase tax-exempt obligations acquired after 1982 will be disallowed.

The interest allocable to tax-exempt obligations shall be determined, except as otherwise provided in regulations prescribed by the Treasury Department, by allocating the taxpayer's otherwise allowable interest deduction (including the deduction for dividends under section 591) to post-1982 tax-exempt obligations by comparing the adjusted basis of those obligations to the adjusted basis of all the taxpayer's assets. For this purpose, calculations of adjusted basis shall be made by averaging adjusted bases of obligations and assets over the course of the taxable year.

DISC

The deemed dividend distribution by a domestic international sales corporation (DISC) to a corporate shareholder (under sec. 995(b)(1)(F)(i)) is increased by 15 percent, to 57½ percent of certain taxable income. This change has the effect of reducing the tax benefit from DISC by 15 percent.

Section 1250 property

The amount treated as ordinary income on the sale or other disposition of section 1250 property (real estate) by a corporation will be increased by 15 percent of the additional amount which would be treated as ordinary income if the property were subject to recapture under section 1245 (the rule applicable to personal property). (This provision will not apply to section 1250 property already subject to full recapture under section 1245.) The minimum tax preference for the remaining 85 percent of the capital gain which would have been ordinary income under section 1245 will be reduced by 28.4 percent (i.e., will equal 71.6 percent of $^{18}/_{46}$ of the gain, or approximately 28 percent of the gain).

In the case of a real estate investment trust (REIT), the amount subject to the 15-percent ordinary income treatment is reduced by the amount of section 1250 capital gain which is distributed to shareholders and is designated as a capital gain dividend. For this purpose, capital gain dividends are deemed to be paid first from section 1250 capital gain. Thus, no section 1250 capital gain is treated as ordinary income where capital gain dividends for the year are more than the section 1250 capital gain. Any gain treated as ordinary income is considered as real estate investment trust taxable income.

Individual shareholders of a REIT continue to treat capital gain dividends as capital gains for purposes of the individual minimum tax. Corporate shareholders of a REIT treat the portion of the capital gain dividend attributable to gain from the sale or exchange of section 1250 property as subject to the 15-percent ordinary income rule. It is expected that the Internal Revenue Service will modify its regulations to require REITs to designate which portion of their capital gain dividends are paid from section 1250 capital gain and the amount of such gain that would be ordinary income if the property were subject to section 1245 recapture so that their corporate shareholders will know the amount of their preference for section 1250 capital gain treatment.

Pollution control facilities

Fifteen percent of the basis of pollution control facilities to which an election under section 169 applies shall be treated as if the election did not apply. The usual rules of ACRS will apply to that portion of the facility (without the 15-percent cutback in the benefit from section 1250 when the property is sold). The minimum tax preference for the remaining property for which 5-year amortization is elected will be reduced by 28.4 percent.

Intangible drilling costs

In the case of an integrated oil company, 15 percent of the amount otherwise allowable as a deduction for intangible drilling costs under section 263(c) will be capitalized to the oil, gas or geothermal property and deducted ratably over a 36-month period beginning with the month the costs are paid or incurred. This provision will not apply to nonproductive wells.

Integrated oil producers are defined as persons who are not independent producers for purposes of the special windfall profit tax rates. Thus, persons with retail sales of $5 million or less and refining of 50,000 barrels per day or less for the taxable year are not subject to the provision.

Mineral exploration and development costs

Fifteen percent of the amounts otherwise allowable as deductions under sections 616 and 617 to a corporation are to be capitalized and treated as if they were used to acquire recovery property assigned to the 5-year class. ACRS deductions (adjusted as provided in sec. 48(q)) will be allowed beginning with the year the expenses are paid or incurred and the investment tax credit will be available in the year the expenses are paid or incurred. However, these costs will not be eligible for safe-harbor leasing. If the property is disposed of, the deductions will be subject to recapture (under sec. 617(d)) and the credit will be subject to recapture under sec. 47 in accordance with the usual recapture rules.

Child care facilities

The minimum tax preference for rapid amortization of child care facilities is deleted.

Effective Dates

The provisions generally apply to taxable years beginning after December 31, 1982. However, the provision relating to deductions under secs. 263(c), 616 and 617 applies to expenditures made after that date; the provision relating to pollution control facilities applies to property placed in service after that date; the provision relating to section 1250 property applies to dispositions after that date; and the provision relating to depletion applies to taxable years beginning after December 31, 1983. The DISC provision applies to taxable years of DISCs beginning after December 31, 1982.

Revenue Effect

The revenue gain is expected to be $515 million in fiscal year 1983, $936 million in 1984, $948 million in 1985, $918 million in 1986, and $995 million in 1987.

2. Basis adjustment for investment tax credits (sec. 205(a) of the Act and sec. 48 and new sec. 196 of the Code)*

Prior Law

In general, under prior law a taxpayer was allowed cost recovery deductions for 100 percent of the cost (or basis) of a depreciable asset, including property for which a regular or energy investment tax credit, or the 25-percent investment credit for rehabilitation expenditures for certified historic structures, was allowed.

However, under both prior law and present law, if the 15- or 20-percent investment credit was claimed for qualified rehabilitation expenditures on a nonresidential building, the basis of the property was reduced by the amount of credit earned. The lower basis was used to compute cost recovery deductions and gain or loss on disposition of the property.

When the investment tax credit was enacted in the Revenue Act of 1962, the basis of the asset was reduced by the full amount of the then 7 percent credit that could be earned. The basis adjustment was repealed in the Revenue Act of 1964.

Reasons for Change

Cost recovery deductions for most personal property allowed under ACRS, in combination with the regular investment tax credit, generated tax benefits which had a present value that was more generous than the tax benefits that would be available if the full cost of the investment could be deducted in the year when the investment was made; i.e., more generous than the tax benefits of expensing. As a result, investments that would not be undertaken in the absence of an income tax became worthwhile because of the excess tax benefits they generated. The allocation of scarce capital resources was distorted, and economic efficiency was reduced.

This incentive for uneconomic investments can be shown with a simple example. Consider a hypothetical system in which taxpayers can claim a deduction for 120 percent of the cost of an asset and there is a 50-percent tax rate. A taxpayer purchases an asset for $100 which earns only $98 in the subsequent year, after which it is scrapped. This investment would clearly be unprofitable in a tax-free world because the $98 return would not be enough even to recoup the $100 paid for the asset, much less any return on the investment. However, in this hypothetical tax system, the $60 tax benefit that the taxpayer receives from the $120 tax deduction reduces his net cost of the asset to $40. Thus, the $49 after tax cash flow in year two is enough to yield a 22.5 percent return after taxes on the investment—enough to make the investment attractive to the taxpayer. This incentive for uneconomic investment would be eliminated if the taxpayer were allowed to expense his $100 investment in the year he made the investment.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 207; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 122-123; and H. Rep. No. 97-760 (August 17, 1982), pp. 481-482 (Joint Explanatory Statement of the Committee of Conference).

In evaluating alternative ways to correct this distortion, Congress concluded that a basis adjustment for one-half of the amount of the regular investment credit allowed would make the combination of ACRS cost recovery deductions and the regular investment credit no more generous than expensing at a 10-percent after-tax discount rate.

Explanation of Provision

The Act requires a taxpayer to reduce the basis of assets by 50 percent of the amount of regular, energy and certified historic structure investment tax credits earned with respect to the property. This applies to credits claimed on qualified progress expenditures as well as on ordinary credits. The basis adjustment applies to all depreciable assets regardless of whether they are eligible for ACRS. The lower basis will be used to compute cost recovery deductions and gain or loss when the asset is disposed of. The Act does not change the full basis adjustment for the 15- and 20-percent rehabilitation credits.

If a credit for which a basis adjustment was required is recaptured, there is an upward basis adjustment of 50 percent of the recapture amount immediately prior to the disposition of the property. Similarly, if a credit for which a basis adjustment was required expires at the end of the carryover period, a deduction is allowed for one-half of the unused credit.

For purposes of determining the amount of ordinary income recaptured under sections 1245 and 1250, the amount of the basis adjustment will be treated as a deduction allowed for depreciation.

Taxpayers are given an opportunity with respect to the regular investment credit on recovery property to elect a 2-percentage point reduction in the credit instead of the basis adjustment. The election is made on a property-by-property basis. In the case of partnerships, the election is made at the partnership level. The election was intended to deal with the case in which a taxpayer cannot claim all the regular investment credits he earns because of the 85-percent-of-tax-liability limitation. In these cases, taxpayers will be able to avoid having to make a basis adjustment by electing the reduced credit.

When lessors elect to pass through the investment credit to lessees under section 48(d), the lessor does not have to make a basis adjustment. Instead, the lessee includes in income ratably over the ACRS recovery period for the property an amount equal to one-half of the credit allowable.[1] Lessees are eligible to elect the 2-percentage point reduction for the regular investment credit, in which case they are not required to include this amount in income. If the credit is recaptured, the income inclusions will be adjusted, in accordance with regulations, to take account of the amount of the credit recaptured.

---

[1] Congress intended that in the case of the 15- or 20-percent rehabilitation credit, the lessee must include in income an amount equal to the full credit allowable.

Effective Date

The requirement for this reduction in basis will generally be effective for property placed in service after December 31, 1982. Rules similar to those under section 48(m) apply. Thus, the basis adjustment will not apply to qualified progress expenditures made before 1983 or to expenditures incurred before 1983 with respect to property constructed by the taxpayer. However, the basis adjustment applies to all amounts paid for property acquired by the taxpayer and placed in service after 1982.

In addition, a transition rule exempts property (which is not public utility property or property subject to a safe-harbor lease) placed in service before January 1, 1986, if the property is acquired or constructed pursuant to a contract entered into after August 13, 1981 (the date of enactment of the Economic Recovery Tax Act of 1981), and which was binding on July 1, 1982, and at all times thereafter.

Generally, the transition rule applies on a property-by-property basis. However, in the case of an integrated manufacturing facility the requirements of the transitional rule are treated as met for all property in the facility if (1) before July 1, 1982, the taxpayer began on-site construction of the facility, (2) during the period between August 13, 1981, and July 2, 1982, the taxpayer constructed (or entered into binding contracts for the construction of) more than 20 percent of the cost of the facility, and (3) all property in the facility was placed in service before January 1, 1986. An integrated manufacturing facility is one or more facilities located on a single site for the manufacture of one or more manufactured products from raw materials by the application of two or more integrated manufacturing processes. For example, an integrated facility for the manufacture of steel or steel products from raw materials would qualify as an integrated manufacturing facility.

There also is a transition rule for rehabilitations of certified historic structures. Expenditures for rehabilitation are exempt from the basis adjustment if the general transitional rule would apply by substituting December 31, 1980, for the August 13, 1981, date in the general rule.

Expenditures for rehabilitations of certified historic structures placed in service before July 1, 1984, also are exempt if, before July 1, 1982, (1) a public offering with respect to interests in the property was registered with the Secutities and Exchange Commission and (2) an application with respect to the property was filed under section 8 of the United States Housing Act of 1937.

Revenue Effect

This provision will increase fiscal year budget receipts by $362 million in 1983, $1,374 million in 1984, $2,658 million in 1985, $4,109 million in 1986, and $5,579 million in 1987.

3. Limitation on investment tax credit (sec. 205(b) of the Act and sec. 46 of the Code)*

Prior Law

The investment tax credit earned by a taxpayer can be used to reduce tax liability up to certain limits. The limit for taxable years ending after 1981 was $25,000 plus 90 percent of tax liability in excess of $25,000 (increased from 80 percent in 1981). Unused credits for a taxable year may be carried back to each of the 3 taxable years preceding the unused credit year and then carried forward to each of the 15 following taxable years.

Reasons for Change

The 90-percent limit on the amount of tax which a taxpayer may offset with the investment credit enables corporations to reduce their tax liability to very low percentages of their taxable income and even lower percentages of their book income as reported to shareholders on financial statements. Congress was concerned that this reduces confidence in the equity of the tax system.

Explanation of Provisions

The limitation on the amount of income tax liability (in excess of $25,000) of an individual or corporate taxpayer that may be offset by the investment tax credit is reduced from 90 percent to 85 percent.

Effective Date

This provision will apply to taxable years that begin after December 31, 1982.

Revenue Effect

This provision will increase budget receipts by $152 million in fiscal year 1983, $259 million in fiscal year 1984, $213 million in fiscal year 1985, $178 million in fiscal year 1986, and $164 million in fiscal year 1987.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 207; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), p. 124; and H. Rep. No. 97-760 (August 17, 1982), pp. 482-483 (Joint Explanatory Statement of the Committee of Conference).

4. Accelerated Cost Recovery System (ACRS) changes for 1985 and 1986 (sec. 206 of the Act and sec. 168 of the Code)*

Prior Law

Overview

The Accelerated Cost Recovery System (ACRS) was enacted in the Economic Recovery Tax Act of 1981 (ERTA). ACRS is a system for recovery of capital costs using accelerated methods over predetermined recovery periods that are generally shorter than were useful lives under pre-ERTA law. The ACRS methods of cost recovery and recovery periods are the same for both new and used property. Recovery of costs generally is determined by using a statutory accelerated method. As an option, the taxpayer may choose to recover costs using the straight-line method over either the regular recovery period or one of the longer recovery periods provided.

Accelerated methods of cost recovery for personal property

In general, the recovery deduction for personal property in each year of the recovery period was, and continues to be, determined by applying a statutory percentage to the unadjusted basis of the property. The applicable percentage depends on the property's class and the number of years since the property was placed in service by the taxpayer.

Three statutory schedules of accelerated recovery percentages were provided for each class of recovery property. One schedule applied to recovery property placed in service in the years 1981 through 1984. The second schedule applied to recovery property placed in service in 1985. The third schedule for each class applied to recovery property placed in service after 1985.

The schedules for personal property placed in service in 1981 through 1984 were developed to approximate the benefits of using the 150-percent declining balance method for the early recovery years and the straight-line method for the later recovery years. The schedules for personal property placed in service in 1985 were developed to approximate the use of the 175-percent declining balance method for the early recovery years and the sum-of-the-years-digits method for the later recovery years. The schedules for personal property placed in service after 1985 were developed to approximate the use of the 200-percent declining balance method for the early recovery years and the sum-of-the-years-digits method for the later recovery years. All of the schedules reflected the allowance of only a half-year of depreciation for the first recovery year and the allowance of the remaining recovery deductions over the remaining recovery years.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 208; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 125-126; and H. Rep. No. 97-760 (August 17, 1982), p. 483 (Joint Explanatory Statement of the Committee of Conference).

Reasons for Change

As explained in the discussion of the basis adjustment (item 2, above), there are strong economic reasons why the combined effect of the investment credit and accelerated depreciation should not be more generous than expensing. Repeal of the scheduled accelerations of depreciation was needed to accomplish Congress' goal of establishing a system that was no more generous than expensing for assets in the 3- and 5-year ACRS classes.

Also, the acceleration of cost recovery deductions after 1984 could have encouraged taxpayers to delay making investments until after that year. Repeal of the scheduled accelerations eliminated that incentive.

Explanation of Provision

The Act repeals the provisions of ACRS that would have accelerated cost recovery rates for personal property to rates approximating the benefits of using a 175-percent declining balance method in 1985 and the 200-percent declining balance method after 1985.

Effective Date

The provisions apply for taxable years ending after the date of enactment.

Revenue Effect

The revenue gain is expected to be $1,541 million in fiscal year 1985, $9,907 million in 1986, and $18,442 million in 1987.

5. Construction period interest and taxes (sec. 207 of the Act and new sec. 189 of the Code)*

Prior Law

Under both present and prior law, individuals, personal holding companies, and subchapter S corporations are required to capitalize interest and real property taxes attributable to the construction period of real property (other than low-income housing) to be used in a trade or business or held for investment (Code sec. 189). The capitalized interest and taxes are amortized (i.e., deducted in equal portions) over certain periods, generally 10 years. The interest that must be capitalized is interest which is attributable to the construction period on any debt incurred or continued for the purpose of acquiring, constructing, or carrying real property other than low income housing. The construction period is defined as the period beginning on the date construction of the building or improvement begins and ending on the date the property is ready to be placed in service or is ready to be held for sale.

The amortization of capitalized interest and taxes begins in the year the interest or taxes were paid or accrued. However, the amortization of capitalized interest and taxes then is suspended until the year the building or improvement is ready to be placed in service or to be sold, and amortization resumes at that time.

Under prior law, corporations, other than personal holding companies and subchapter S corporations, were not subject to the capitalization requirement of section 189. For these corporations, amounts paid or accrued for interest and real property taxes were allowed as deductions for the year in which paid or accrued. However, under both present and prior law, certain prepaid interest must be capitalized and deducted in the years to which properly allocable. In addition, under both present and prior law, taxpayers may capitalize certain taxes and interest attributable to both real and personal property and include the capitalized items in the basis of the property (Code sec. 266).

Reasons for Change

The allowance of a deduction for construction period interest and taxes is contrary to the fundamental accounting principle of matching income and expenses. Generally, a current expense is deductible in full in the taxable year paid or accrued because it is necessary to produce income and is usually consumed in that process. However, some expenditures are made prior to the receipt of income attributable to the expenditures and, under the matching concept, these expenditures should be treated as a future expense when the income "resulting" from the expenditure is received.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 209; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 127-129; Senate floor amendments 128 Cong. Rec. S8961-8962 (July 22, 1982) and S 8977-8982 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 484-486 (Joint Explanatory Statement of the Committee of Conference).

In the case of a taxpayer who constructs a building and subsequently receives income in the form of rents from that building, the accounting concept of matching income against expenses requires that the expenses incurred during the construction period be deducted against the rental income which is received over the life of the building, to the extent the expenses are attributable to a depreciable or wasting asset. The general construction costs of the building are treated this way, being capitalized and subsequently deducted as depreciation expenses. Similarly, certain pre-opening or start-up expenses for a new trade or business are required to be capitalized for tax accounting purposes.

Congress believed that construction period interest and taxes, as other costs of construction such as labor and materials, generally should be capitalized and deducted only when the real property is sold or is used to produce income. In the case of real property other than low-income housing, these rules have applied to individuals, subchapter S corporations, and personal holding companies since section 189 was added to the Code in the Tax Reform Act of 1976.

Corporations, other than personal holding companies and subchapter S corporations, were not required to capitalize construction period interest and taxes. The ability to deduct currently construction period interest and taxes permitted the deferral of tax on current income, which was the equivalent of an interest-free loan from the Government that could be a significant economic benefit. Congress believed that this situation was not compatible with the general objective of matching income and expenses. Congress, therefore, decided that corporations should be required to capitalize construction period interest and taxes. However, Congress also believed, that, it was appropriate to limit this requirement to nonresidential construction.

Explanation of Provision

Section 189 is extended to require corporations (other than subchapter S corporations and personal holding companies) to capitalize construction period interest and taxes for nonresidential real property. The definition of the construction period for corporations is the same as under present section 189.[1] Construction period interest and taxes for nonresidential real property are real property taxes for nonresidential real property and interest paid or accrued on debt incurred or continued to acquire, construct, or carry nonresidential real property, but only to the extent such taxes and interest are attributable to the construction period for such property. The Act requires the Treasury Department to issue regulations allocating interest to expenditures for real property during construction. Congress expected that these regulations will adopt rules similar to those contained in Financial Accounting Standards Board Statement Number 34, as amended. Under those rules, the amount of interest to be capitalized is the portion of the total interest expense incurred during the construction period that could have been avoided if funds had not been expended for construction. Interest expense that could have been avoided includes interest costs incurred by reason of additional borrowings to finance construction and interest costs incurred by reason of borrowings that otherwise could have been repaid with funds expended for construction.

---

[1] For purposes of this provision, the growing of trees or other crops is not to be considered an improvement in real property.

Congress understood that the construction period commences with the date on which the construction of a building or other improvement begins and ends on the date that the building or improvement is ready to be placed in service or is ready to be held for sale. For this purpose, the construction period is not to be considered to have commenced solely because drilling is performed to determine soil conditions, architect's sketches or plans are prepared, or a building permit is obtained. Generally, the construction period will be considered to have commenced when land preparations and improvements, such as clearing, grading, excavation, and filling, are undertaken. However, the construction period will not be considered to have commenced solely because clearing or grading work is undertaken, or drainage ditches are dug, if such work is undertaken primarily for the maintenance or preservation of raw land and existing structures and is not an integral part of a plan for the construction of new or substantially renovated buildings and improvements. In the case of the demolition of existing structures where the construction period has not otherwise commenced, the construction period is considered to commence when demolition begins if the demolition is undertaken to prepare the site for construction. The construction period will not be considered to commence solely because of the demolition of existing structures if the demolition is not undertaken as part of a plan for the construction of new or substantially renovated buildings or improvements.

Effective Date

The Act generally applies to interest and taxes paid or incurred in taxable years beginning after December 31, 1982, for the construction of nonresidential real property begun after December 31, 1982. The Act does not apply, however, to the construction of the Alaska Natural Gas Transportation System (15 U.S.C. 719) and its related facilities (e.g., compressor stations and conditioning plants). In addition, the Act does not apply to the construction of hotels or motels (described in Code sec. 48(a)(3)(B)), or the construction of hospitals and nursing homes, begun before January 1, 1984, if the construction is done under a written plan of the taxpayer in existence on July 1, 1982, and if the taxpayer has requested in writing approval from a governmental unit for such construction.

Congress intended that the construction of property is considered to have begun before January 1, 1983, if the property is an integral part of an integrated facility and construction of part of that facility began before January 1, 1983. An integrated facility is a multiproperty facility constructed as a single project on a single site and operated as a single, unitary facility as described in a written plan (evidenced by internal documents of the taxpayer such as purchasing and financing documents) exisiting on July 1, 1982. Property is an integral part of an integrated facility if:

(1) the property is described as part of the same project in written plans of the taxpayer in existence on July 1, 1982;

(2) the property is an integral part of the planned operation of the project when the project will first be placed in service; and

(3) the property will be constructed during the same construction period as the rest of the project.

Thus, for example, three nuclear reactors are not part of one integrated facility for the production of electricity if it is planned that only one reactor will be placed in service initially. On the other hand, if a taxpayer plans to construct a facility to produce sheet steel from iron ore, then both a blast furnace and rolling mill to be constructed during the same construction period on a single site are part of the same integrated facility because both properties are necessary to produce sheet steel from iron ore as contemplated in the taxpayer's plan. However, if the blast furnace is planned to be ready to be placed in service in 1985 and construction of the rolling mill is not planned to begin until 1986, then those properties are not part of one integrated facility.

Although improvements such as parking lots, access roads, and utility hook-ups may be part of an integrated facility, the start of construction of such property (which can be used in connection with any type of facility) is not considered the start of construction of other property in the facility for purposes of the effective date of the provision.

Revenue Effect

This provision is expected to increase fiscal year budget receipts by $555 million in 1983, $1,179 million in 1984, $1,206 million in 1985, $1,084 million in 1986, and $819 million in 1987.

6. Modification to leasing rules (secs. 208, 209, 210, and 217(c) of the Act and secs. 48(b), 103(b)(9) and 168 of the Code)*

Prior Law

Overview

Prior to the enactment of the Economic Recovery Tax Act of 1981 (ERTA), the law contained rules (non-safe harbor lease rules) to determine who owns an item of property for tax purposes when the property is subject to an agreement which the parties characterize as a lease. Such rules are important because the owner of the property is the person entitled to claim cost recovery (depreciation) deductions and investment tax credits. The non-safe harbor lease rules attempted to distinguish between true leases, in which the lessor owned the property for tax purposes, and conditional sales or financing arrangements, in which the user of the property owned the property for tax purposes. These rules generally were not written in the Internal Revenue Code; instead they evolved over the years through a series of court cases and revenue rulings and revenue procedures issued by the Internal Revenue Service. Essentially, the law was that the economic substance of a transaction, not its form, determined who was the owner of property for tax purposes. Thus, if a transaction was, in substance, simply a financing arrangement, it would be treated that way for tax purposes regardless of how the parties chose to characterize it. Lease transactions could not be used solely for the purpose of transferring tax benefits. They had to have nontax economic substance. The specific prior law rules are discussed below.

ERTA provided a new set of rules which represented a major departure from the prior law. These provisions were intended to be a means of transferring tax benefits rather than a means of determining which person is in substance the owner of the property. Under these rules, certain transactions involving tangible personal property were treated as leases for Federal income tax purposes regardless of their nontax economic substance. If a transaction met these safe harbor requirements, the lessor in the agreement was treated as the property owner for Federal income tax purposes and was entitled to cost recovery deductions and investment credits. Under these rules, by entering into a nominal sale and safe-harbor leaseback, a person who acquired and used the property could have, in effect, sold some of the tax benefits associated with the property to a corporation, while retaining all other economic benefits and burdens of ownership. The non-safe harbor leasing rules continued to apply for transactions not qualifying for the safe harbor or when the safe harbor was not elected.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, secs. 211, 212, and 213; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 130-145; Senate floor amendments, 128 Cong. Rec. S. 8642-43 (July 19, 1982), S 8913, S 8915, S 8971-8973, S 8983, and S 9016-9017 (July 22, 1982); H. Rep. No. 97-760 (August 17, 1982), pp. 487-500 (Joint Explanatory Statement of the Committee of Conference); and H. Con. Res. 398, 128 Con. Rec. H6636 (August 19, 1982).

Also, see H.R. 6056, Technical Corrections Act of 1982, as reported by the Senate Finance Committee, sec. 306, S. Rep. No. 97-592 (Sept. 27, 1982), pp. 53-54; House floor amendments, 128 Cong. Rec. H9600-9604; H. Rep. No 97-986 (Dec. 21, 1982), pp. 19-20, 26-27 (Joint Explanatory Statement of the Committee of Conference).

Non-safe harbor leasing rules

Underlying principles

In general, the determination of lease treatment under the non-safe harbor leasing rules required a case-by-case analysis based on all facts and circumstances. Although the determination of whether a transaction was a lease was inherently factual, a series of general principles was embodied in court cases, revenue rulings, and revenue procedures. Those principles are still used in determining the character of transactions that are not eligible for the safe-harbor rules or for which the safe-harbor election is not made.

For a transaction to be a lease under non-safe harbor lease rules, the lessee could not hold title to or have an equity interest in the property. However, the fact that the lessor had title did not guarantee that the lessor was the owner for Federal income tax purposes. Both the courts and the IRS looked to additional criteria in determining whether a transaction was a lease. These criteria focused on the substance of the transaction rather than its form. The courts did not disregard the form of a transaction simply because tax considerations were a significant motive so long as the transaction also had a bona fide business purpose and the lessor retained sufficient burdens and benefits of ownership.[1]

To be entitled to depreciation deductions as the owner of the property, the lessor had to show that the property was being used for a business or other income-producing purpose. To have had a business purpose, the person claiming ownership (i.e., the lessor) at least had to have a reasonable expectation that he would derive a profit from the transaction independent of tax benefits.[2] This requirement precluded lease treatment for a transaction intended merely to reduce the user's costs by utilizing the lessor's tax base. For a sale-leaseback, other nontax business motives were considered in determining the substance of the transaction.

The fact that the lessor in a lease financing transaction could show a profit or business purpose, however, did not automatically result in lease treatment under prior law rules, since a profit or business motive could also exist in a financing arrangement. In addition, the lessor had to retain meaningful benefits and burdens of ownership.[3] Thus, lease treatment was denied under prior law rules if the user had the option to obtain title to the property at the end of the lease for a price that either was nominal in relation to the value of the property at the time when the option could be exercised (as determined at the time the parties entered into the agreement) or which was relatively small when compared with the total payments required to be made.[4]

---

[1] *See, Hilton* v. *Commissioner*, 74 T.C. 305 (1980), *aff'd* 671 F.2d 316 (9th Cir. 1982); *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978), *rev'g.* 536 F.2d 746 (8th Cir. 1976); Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein); *see generally, Gregory* v. *Helvering*, 293 U.S. 465 (1935).

[2] *See, Hilton* v. *Commissioner*, 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982).

[3] *See, Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978), *rev'g.* 536 F.2d 746 (8th Cir. 1976); Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein).

Where the residual value of the property to the lessor was nominal, the lessor was viewed as having transferred full ownership of the property for the rental fee. Where the purchase option was more than nominal but relatively small in comparison with fair market value, the lessor was viewed as having transferred full ownership because of the likelihood that the lessee would exercise the bargain purchase option.[5] Furthermore, if the lessor could force the lessee to purchase the property at the end of the lease (a "put"), the transaction might also be denied lease treatment under prior law because the put eliminated the risk borne by owners of property that there would be no market for the property at the end of the lease.

Objective guidelines used in structuring transactions

The question of exactly what burdens and benefits of ownership had to be retained by the lessor under non-safe harbor lease rules created some confusion for people trying to structure leases that, at least in part, were motivated by tax considerations. To give taxpayers guidance in structuring leveraged leases (i.e., where the property is financed by a nonrecourse loan from a third party), the Internal Revenue Service in 1975 issued Revenue Procedure 75-21, 1975-1 C.B. 715, and a companion document, Revenue Procedure 75-28, 1975-1 C.B. 752 (the guidelines). If the requirements of the guidelines were met and if the facts and circumstances did not indicate a contrary result, the Service issued (and continues to issue) an advance letter ruling under the prior law rules that the transaction was a lease and that the lessor was the owner for Federal tax purposes.

The guidelines applied only to leveraged leases of equipment. The general principles described above continued to govern nonleveraged leases and leases of real property. The guidelines were not by their terms a definitive statement of legal principles and were not intended for audit purposes. If all requirements of the guidelines were not met, a transaction might still be considered a lease if, after considering all facts and circumstances, the transaction was a lease under the general principles discussed previously. However, in practice, many taxpayers took into account the guidelines' requirements in structuring transactions. The guidelines may be viewed as a type of safe harbor.

The specific requirements for obtaining a ruling under the guidelines are as follows:

1. *Minimum investment.*—The lessor must have a minimum 20 percent unconditional at-risk investment in the property. This rule represents an attempt to ensure that the lessor suffers some significant loss if the property declines in value.

2. *Purchase options.*—In general, the lessee may not have an option to purchase the property at the end of the lease term unless,

---

[4] *See,* Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein).

[5] *See, M&W Gear Co.* v. *Commissioner,* 446 F.2d 841 (7th Cir. 1971).

under the lease agreement, the option can be exercised only at fair market value (determined at the time of exercise). This rule precludes fixed price purchase options, even at a bona fide estimate of the projected fair market value of the property at the option date. In addition, when the property is first placed in service by the lessee, the lessor cannot have a contractural right to require the lessee or any other party to purchase the property, even at fair market value (a put).

The fair market value purchase option requirement fulfills three purposes related to the determination of the economic substance of the transaction. First, it ensures that the lessor bears the risk implicit in ownership that no market will exist at the end of the lease. The owner of depreciable property is the person who bears any decline in value of the asset. Second, it ensures that the lessor has retained an equity interest in the property. Any fixed price option represents a limitation on the lessor's right of full enjoyment of the property's value. Third, it limits the ability of the parties to establish an artificial rent structure to avoid the cash flow test (described below). However, several courts have held that the mere existence of a fixed price purchase option does not prevent lease treatment so long as the lessor retains other significant burdens and benefits of ownership.[6]

3. *Lessee investment precluded.*—Neither the lessee nor a party related to the lessee may furnish any part of the cost of the property. The rationale is that a lessee investment may suggest that the lessee is in substance a co-owner of the property.

4. *No lessee loans or guarantees.*—As a corollary to the prior rule, the lessee must not loan to the lessor any of the funds necessary to acquire the property. In addition, the lessee must not guarantee any lessor loan.

5. *Profit and cash flow requirements.*—The lessor must expect to receive a profit from the transaction and have a positive cash flow from the transaction independent of tax benefits. As mentioned previously, a profitability requirement is based on the requirement that lease transactions must have a business purpose independent of tax benefits.

6. *Limited use property.*—Under Revenue Procedure 76–30, 1976–2 C.B. 647, property that can be used only by the lessee (limited use property) is not eligible for lease treatment. The rationale is that if the lessee is the only person who could realistically use the property, the lessor has not retained any significant ownership interest.

Recent developments in the case law

There have been several recent decisions by the courts relating to the characterization of transactions as leases under non-safe harbor lease rules. The first of these cases is the Supreme Court decision in *Frank Lyon* v. *United States*,[7] which deals with a sale-leaseback of real property financed by the lessor with cash and recourse debt. In *Frank Lyon*, the Supreme Court held that the transaction was a lease and stated that where there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Among the many factors the court cited for its decision was the fact that there was a business purpose for the sale-leaseback, as evidenced by the fact that State and Federal regulations prohibited the lessee-bank from borrowing a sufficient amount to finance construction, that diversification was the lessor's principal motive, and that the depreciation deductions would have been equally available to the lessee-bank had it retained title. The court also held that the lessee's option to purchase, though fixed, was for a reasonable amount, and that the lessor bore the risk that the lessee would not exercise that option if the price was more than the fair market value of the property. The facts in *Frank Lyon* indicated that the lessor would realize an overall profit from the transaction independent of tax benefits if the lessee exercised its option to purchase.[8]

---

[6] *See, e.g., Northwest Acceptance Corp.* v. *Commissioner*, 58 T.C. 836 (1972), *aff'd*, 500 F. 2d 1222 (9th Cir. 1974).

[7] 435 U.S. 561 (1978), *rev'g*, 536 F.2d 746 (8th Cir. 1976).

Another important decision dealing with non-safe harbor lease rules is *Swift Dodge* v. *Commissioner*.[9] In *Swift Dodge*, an automobile dealership operated a separate leasing business. The company acquired most of its cars for lease from amounts borrowed from banks on a recourse basis. The auto dealer-lessor obtained a profit from the leases independent of tax benefits. The lease contained a terminal rental adjustment clause that permitted an upward or downward adjustment of rent to make up for any difference between the projected value of the property at the end of the lease and the actual value of the property upon lease termination.

The Tax Court held that these nonleveraged transactions were leases and not conditional sales. It cited the general rule that economic substance prevails over form and cited *Frank Lyon* for its statements regarding the necessity of the lessor retaining significant and genuine attributes of the traditional lessor form. It stated that a transaction is a lease if the lessor assumes burdens other than those of a lender and is subject to significant risk not ordinarily incident to a secured loan.

Safe harbor leasing rules

Overview

The safe-harbor leasing provisions of ERTA were intended to permit owners of property who were unable to use depreciation deductions and investment credits to transfer those benefits to persons who were able to use them, without having to meet the prior law requirements for characterizing the transaction as a lease. The safe-harbor leasing provisions operated by guaranteeing that, for Federal income tax purposes, qualifying transactions were treated as leases, and that the nominal lessor was treated as the owner of the property, even though the lessee was in substance the owner of the property and the transaction otherwise would not have been considered a lease.

---

[8] In *Hilton* v. *Commissioner*, 74 T.C. 305, 348–49 (1980), *aff'd.*, 671 F.2d 316 (9th Cir. 1982), the court, in applying the *Frank Lyon* test to deny lease treatment, stated that the taxpayers must show not only that their participation in a sale-leaseback was not motivated by tax avoidance features that have meaningless labels attached, but also that there is economic substance to the transaction independent of the apparent tax shelter potential.

[9] 76 T.C. 547 (1981), *rev'd*, Docket No. 81–7440 (9th Cir. November 19, 1982). After the enactment of the Tax Equity and Fiscal Responsibility Act of 1982, the ninth circuit reversed the Tax Court, holding that the transaction was in substance a conditional installment sale with a lump-sum final payment. The court concluded that the only risk borne by the lessor was the risk of default by the lessee, which is the same risk that would be assumed by the holder of a security interest.

Eligibility requirements

To qualify for the safe harbor, a transaction had to meet the following requirements:

1. All parties to the agreement had to elect to have the transaction treated as a lease for Federal income tax purposes;
2. The nominal lessor had to be (a) a corporation (other than a subchapter S corporation or a personal holding company), (b) a partnership all of the partners of which were one of the corporations described in (a), or (c) a grantor trust with respect to which the grantor and all beneficiaries of the trust were corporations or a partnership comprised of corporations;
3. The lessor had to have a minimum at-risk investment in the property at all times during the lease term of at least ten percent of the adjusted basis of the property; [10]
4. The lease term could not exceed the greater of 90 percent of the property's useful life or 150 percent of the ADR midpoint life of the property; and
5. The property had to be "qualified leased property."

Qualified leased property

In general, qualified leased property meant new equipment eligible for both ACRS and the investment credit. The equipment could be leased within 3 months after the property was placed in service without violating the requirement that the equipment be new equipment (called the 3-month window).

Property used by a tax-exempt organization or a U.S. Federal, State, or local governmental unit generally was ineligible. However, under a special exception, qualified mass commuting vehicles financed in whole or in part by tax-exempt bonds were eligible even though the property was used by a tax-exempt organization or governmental unit. For mass commuting vehicles, the lessor was eligible for ACRS deductions but not the investment credit.

Factors disregarded

If a transaction met the safe-harbor requirements, the transaction was treated as a lease entered into by the parties to the agreement, and the nominal lessor was treated as the owner for Federal income tax purposes. Thus, the nominal lessor was entitled to the associated cost recovery allowances and investment credit. The following factors, therefore, were not taken into account in determining whether a transaction was a lease, as they had been under the non-safe harbor lease rules:

---

[10] This safe-harbor rule differed from the corresponding non-safe harbor lease rule in two respects. First, the minimum investment was reduced from 20 percent to 10 percent under the safe harbor. Second, the minimum investment did not have to be maintained at the same level throughout the lease term since the test was applied with reference to adjusted basis (original basis reduced by depreciation deductions).

1. The fact the lessor or lessee had to take the tax benefits into account in order to realize a profit or positive cash flow from the transaction;
2. The fact the lessee had to be the owner of the property for State or local law purposes (e.g., had title to the property and retained the burdens, benefits, and incidents of ownership, such as payment of taxes and maintenance charges with respect to the property);
3. The fact that no person other than the lessee was able to use the property after the lease term;
4. The fact the property was, or had to have been, bought or sold at the end of the lease term at a fixed or determinable price or the fact that a rental adjustment was made upward or downward to reflect the difference between the expected residual value of the property and the actual sales price; and
5. The fact the lessee, or a related party, provided financing or guaranteed financing for the transaction (other than the lessor's minimum 10 percent investment).

Amount and timing of deductions and credits

The legislative history of the safe-harbor provisions suggested that a lessor's basis in the leased property included the entire amount of any obligation with respect to the property even if the obligation of the lessor was contingent or offset by rental payments. This rule, which overrode prior case law, eliminated the need for the parties to actually make the offsetting payments to ensure the tax consequences of basis, income, and deductions that would have occurred if the payments had been made. However, the lessor had to report as income all rental payments due, even if not actually received because of the offset agreement.

In addition, the legislative history suggested that the lessor had to report the rental income on a ratable basis, eliminating the deferral of income to the lessor that would result by virtue of, for example, a balloon payment agreement. With respect to interest deductions, calculations under a level payment mortgage assumption were permitted.

Description of safe-harbor transactions

The safe-harbor rules were used to guarantee lease treatment for several types of transactions. Most of these transactions fell into two categories. The transactions in the first category were often referred to by practitioners as tax benefit transfers because their only purpose was the transfer of tax benefits. (Another name used was wash sale-leasebacks.) Although the safe harbor was used primarily for this purpose, it also was used to guarantee lease treatment for lease financings, which involve nontax business considerations.

Tax benefit transfers

Treasury regulations contemplated that those who used the safe-harbor leasing rules for tax benefit transfers would structure their transactions as a particular kind of sale and leaseback. This type of transaction involved three steps. First, the seller/lessee (who may be either an individual or a corporation) acquired the property with its own funds or borrowed funds and then, within three months, transferred it in a nominal "sale" to the buyer/lessor. In exchange, the seller/lessee received cash for a part of the selling price and a level payment nonrecourse note for the balance. The seller/lessee continued to use the property and typically enjoyed all the economic benefits and burdens of ownership. In the standard transaction, the user of the property retained all incidents of State law ownership. For Federal income tax purposes, however, the buyer/lessor claimed the cost recovery deductions and investment credits allowable for the property. The second step was that the seller/lessee nominally leased the property back from the buyer/lessor. The lease rental payments to the buyer/lessor were structured so as to equal the debt service payments to the seller/lessee arising from the nonrecourse note in stage one. Thus, no cash changed hands during this second stage. However, because the debt service payment consisted of both interest and principal, the excess of lease rent over interest for any taxable year (which equals the principal repaid in the year) was treated for Federal income tax purposes as income to the buyer/lessor and as a deduction for the seller/lessee. Third, at the end of the lease, the seller/lessee nominally repurchased the property for a token amount, such as $1.

The substantive effect of this sale-leaseback transaction was that the buyer/lessor had purchased a stream of tax benefits from the seller/lessee for an amount equal to the cash paid for the property during the first stage of the transaction. (This is the only cash which changed hands, apart from the nominal amount paid for repurchase of the property in stage three.) The stream of tax benefits purchased by the buyer/lessor equaled the ACRS cost recovery deductions, plus the investment tax credit (including the energy credit if applicable), minus the net rental income arising from the lease (the excess of lease rentals over interest on the nonrecourse note, which precisely equaled the principal payments on the note).[11]

Lease financing

In addition to tax benefit transfers, the safe-harbor leasing provisions were used to guarantee lease treatment for lease financing transactions that failed to meet all of the requirements of the guidelines. Often, the requirement of the guidelines that these lessors and lessees wanted to avoid was the prohibition on options for the lessee to purchase the property at a fixed price determined at the time of the agreement. The safe harbor also was used to guarantee lease treatment for lease financings that involved terminal rental adjustment clauses.

---

[11] As an alternative to this type of transaction, in which the user held State law title to the property, a tax benefit transfer could have been structured in the following manner: First, a bank or other financing party acquired the property and leased it to the user in a transaction that met the requirements for lease treatment under Rev. Proc. 75-21. Second, the lessor did a safe-harbor sale and leaseback to transfer the tax benefits to another party. The distinguishing feature of this type of tax benefit transfer was that the bank or other financing party rather than the user was the actual owner of the property.

Also, the 3-month window in the safe-harbor rules encouraged businesses to use the safe harbor because they did not have to finalize their lease by the exact date on which the property was put in service. Under the non-safe harbor rules, if a sale and leaseback was entered into after the property was placed in service, the property could be characterized as used property and subjected to the limits on the investment credit for used property.

Recapture rules

If the lessee acquired the property from the lessor at the end of the lease and subsequently disposed of it, the lessee was subject to the recapture rules under sections 47 and 1245 as if the lessee had been considered the owner of the property for the entire term of the lease, except that any amount recaptured by the lessor was not recaptured again by the lessee. For example, assume the lessor claimed $100 of cost recovery allowances for 5-year recovery property over the lease term and had a zero adjusted basis in the property at the end of the lease. The lessor sold the property to the lessee for $1.00. The lessee subsequently sold the property to a third party for $80. The lessor would have had a $1 gain on the sale to the lessee, all of which would have been treated as ordinary income under the section 1245 recapture rules. The lessee would have had $79 gain ($80 sales price—$1 cost basis) all of which would have been treated as ordinary income under the section 1245 recapture rules.

Reasons for Change

Congress concluded that it was necessary to reduce safe-harbor leasing and ultimately to repeal it. The principal considerations were the tax avoidance opportunities that safe-harbor leasing had created, the adverse public reaction to the sale of tax benefits, the revenue loss, the equitable transition to repeal and the feasibility of alternative approaches.

Congress was concerned that the prior law safe-harbor rules had enabled some taxpayers to avoid their equitable share of tax. This included the use of safe-harbor leasing to increase tax benefits not associated with investment in machinery and equipment (like percentage depletion), to avoid payment of any tax and to generate tax refunds. In addition, Congress believed that the adverse public reaction to such practices and to the institutionalized commerce in tax deductions and credits was too likely to diminish respect for and compliance with the tax laws on the part of the general taxpayer.

Congress also was concerned that the revenue cost of the prior law safe-harbor rules was too large, in light of projected budget deficits, the uncertain public benefits and the feasibility of less costly approaches. Congress decided that one objective of safe-harbor leasing, to forestall tax-motivated mergers, could be advanced directly by tighter legislation in that area, as provided in the Act. It decided that the other objective, to assist businesses that could not currently make full use of ACRS deductions and credits, could be advanced at a smaller cost by liberalizing rules relating to the tax treatment of leases that have economic substance.

Therefore, Congress concluded that safe-harbor leasing should be restricted and then repealed, under transition rules that restrict tax avoidance possibilities, lessen the revenue loss, and afford taxpayers equitable opportunities to adjust to the change in law.

Explanation of Provisions

The Act modifies in two basic steps the rules relating to lease treatment for Federal income tax purposes. First, it provides new rules that reduce the tax benefits of safe-harbor leasing. These rules generally apply to agreements entered into between July 1, 1982 (or property placed in service after that date) and January 1, 1984. Second, the Act repeals safe-harbor leasing on January 1, 1984, and provides liberalized rules for leases with economic substance that are entered into on or after that date.

a. Safe harbor leasing rules

Overview

Prior to the repeal of safe-harbor leasing, the Act modifies the rules governing safe-habor leases in several respects.

To limit the present value of the tax benefits under a safe-harbor lease, the Act generally reduces the maximum allowable lease term and interest rate and slows down the timing of ACRS deductions and investment credits that may be claimed by the lessor. The Act also limits the extent to which the lessor may reduce its tax liability through safe-harbor leasing.

The Act excludes certain types of property from the definition of qualified leased property. Public utility property is made ineligible for safe-harbor lease treatment, as is property used by a person other than a U.S. person if the income from use of the asset by that person is not subject to U.S. tax. Certain formerly tax-exempt organizations are prevented from using safe-harbor leasing.

The Act limits the amount of the lessee's property that may be leased, restricts the ability of lessees to increase percentage depletion through safe-harbor leasing and prohibits the lessee from entering into a safe-harbor lease with a related party.

Investment tax credit strips, which are transactions intended to permit the lessee to transfer the investment credit only, are allowed for transactions entered into before October 20, 1981. Also, the Act liberalizes the at-risk rules for closely-held lessors.

The modifications of the safe-harbor lease provisions apply generally for leases entered into, or property placed in service, after July 1, 1982. However, the Act provides transitional rules, which exclude certain property from most of these modifications.

Eligibility requirements

The Act retains the election requirement, the minimum investment requirement, and the requirement that the lessor in a safe-harbor lease must be a corporation, a partnership of corporations, or a grantor trust all beneficiaries of which are corporations. However, the Act modifies the rules relating to the maximum lease term.

The Act generally reduces the maximum allowable term of a safe-harbor lease. This term cannot exceed the greater of (1) 120 percent of the asset depreciation range (ADR) midpoint life of the leased property (as of January 1, 1981) or (2) the extended recovery period over which ACRS deductions are allowed under the Act for the leased property. As discussed below, the extended recovery periods applicable to property under a safe-harbor lease are 5 years for 3-year property, 8 years for 5-year property, and 15 years for 10-year property.

Qualified leased property

In general, qualified leased property eligible for safe harbor leasing is defined the same as under prior law. Thus, the property must be new property eligible for ACRS and the investment credit (other than a rehabilitated building) or must be a mass commuting vehicle. However, the Act excludes a number of categories of previously eligible property, as described below.

Property used by former tax-exempt organizations

Under the Act, qualified leased property does not include property (other than mass commuting vehicles) leased to a person currently subject to Federal income tax that was a tax-exempt organization at any time within the 5-year period preceding the date of the lease agreement. This rule also applies where a predecessor of the lessee, within the 5-year period, was a tax-exempt organization and was engaged in activities substantially similar to the activities in which the lessee is engaged. However, the Act does not exclude from eligible property any property used by a former tax-exempt organization in a trade or business unrelated to its former exempt function if the income from that trade or business was subject to tax under section 511. Also, property used by certain farmers cooperatives is eligible for safe-harbor leasing whether or not the cooperative is tax exempt. The Secretary shall have authority to prescribe appropriate rules to carry out the purposes of this provision.

Public utility property

Public utility property, as defined in section 167(l)(3)(A), is made ineligible for safe-harbor leasing.

Property used by a foreign person

Under the Act, qualified leased property does not include property used by a person other than a U.S. person if the income from use of the asset by that person is not subject to U.S. tax.

Mass commuting vehicles

The Act clarifies that ferries used for mass transportation services qualify as mass commuting vehicles. However, as under prior law, all other vehicles must be used for mass commuting services to qualify. For example, school buses do not qualify.

Limitations on lessee

Lessee cap on amount of eligible property

Under the Act, the safe harbor will apply with respect to no more than 45 percent of the cost of the lessee's qualified base property placed in service during any calendar year. Qualified leased property that is not subject to the amendments made by the Act by virtue of the July 1, 1982, general effective date rule or the transitional rules counts toward the lessee cap, but the rule does not operate to deny safe-harbor lease treatment for leases of that property. For example, if 50 percent of a lessee's qualified base property placed in service in 1982 were subject to the transitional rules, that property would not be affected by the cap. However, the lessee could not safe harbor lease any more of its property in 1982. If only 25 percent of a lessee's qualified base property placed in service in 1982 were subject to the transitional rules, it could safe harbor lease an additional 20 percent of its eligible property during the remainder of 1982.

For this purpose, the lessee's qualified base property includes the cost basis of all qualified leased property leased by the lessee under a lease for which a safe-harbor election has been made and all other new section 38 property owned by the lessee and placed in service during the calendar year. A lessee's qualified base property for this purpose also includes designated leased property with respect to which the taxpayer is the lessee. Designated leased property is new section 38 property leased under a non-safe harbor lease for a term that is more than 50 percent of the ADR midpoint life (or, if there is no ADR life, 50 percent of the extended ACRS period applicable to a lessor under the new safe-harbor rules). The lessor must be treated as the owner of the property without regard to the safe-harbor lease provisions.

The Secretary shall prescribe rules for applying this limitation on a consolidated basis for companies filing consolidated returns.

For any year in which this limitation applies, property leased last during the year is the first property to be excluded from the safe harbor. The exclusions thus occur in reverse chronological order. If the limitation applies to a portion of leased property, the safe harbor will continue to apply to the portion that does not exceed the limitation.

Limitations on lessee's percentage depletion

The Act limits the extent to which the lessee can use safe-harbor leasing to increase its percentage depletion deductions. Under the Act, the lessee must compute both the 50-percent and 65-percent taxable income limitations on percentage depletion deductions as if it were the owner of the property. Thus, for this purpose, the lessee must take into account ACRS deductions for the property and must disregard lease rentals and interest on lessee financing. In computing the imputed ACRS deductions for the property, the lessee must use the recovery period and method applicable to the lessor under the new safe-harbor rules.

Limitations on use by lessor

Lessor cap on current tax liability

The Act provides a 50-percent limit on the amount by which a lessor can reduce its income tax liability (including any liability under the add-on minimum tax) through safe-harbor leasing in taxable years ending after July 1, 1982 (lessor cap). That is, a lessor's tax liability is the greater of (1) 50 percent of the liability computed without regard to any rental income, interest deduction (if paid or incurred to the lessee), cost recovery deduction, and investment credit taken into account for the taxable year pursuant to a safe-harbor lease (safe-harbor lease items), or (2) the taxpayer's liability computed with regard to those safe-harbor lease items.

When tax liability is determined by operation of the 50-percent limitation, deductions or credits from safe-harbor leases are not allowable in the current taxable year to the extent they reduce the lessor's tax liability below the proper amount of tax determined under the lessor cap. Such deductions or credits may be carried forward and treated as allocable to safe-harbor lease property in the taxable year to which they are carried. The Secretary shall prescribe regulations for determining what deductions or credits are to be allowed in the current year and what deductions or credits are to be carried forward.

For example, assume that a lessor's tax would be $100 if safe-harbor lease items were excluded and $30 if they were included. The 50-percent limit would apply in this case and the lessor's tax liability would be $50 (50 percent of $100). Under regulations prescribed by the Secretary, deductions or credits are to be disallowed in the current taxable year to the extent they reduce the lessor's tax liability from $50 to $30. The unused deductions and credits may be carried forward.

No deferral of safe-harbor lease benefits will be required with respect to a safe-harbor lease that is not subject to the amendments made by the Act by virtue of the July 1, 1982, general effective date rule or the transition rules (as described below). However, these leases are taken into account first for taxable years ending after July 1, 1982, in determining whether there is a deferral of safe-harbor lease benefits for leases that are subject to the amendments made by the Act.

For example, assume all of a lessor's safe-harbor lease items are attributable to transitional rule leases. The lessor's tax liability would be $100 if those items were excluded and $50 if they were included. Under those facts, no deductions or credits would be disallowed. However, if in addition the lessor had entered into any safe-harbor leases not covered by the transitional rules, all deductions and credits attributable to those leases would be denied.

Restrictions on carrybacks

The Act contains rules to prevent safe-harbor lessors from using tax benefits obtained through safe-harbor leasing to generate net operating loss or investment credit carrybacks to prior taxable years. Under these rules, a taxpayer's net operating loss carryback for any taxable year is reduced (and cannot be increased) by the portion of the carryback which is due to rental income, interest deductions attributable to interest paid to the lessee, depreciation deductions and investment credits relating to property with respect to which the taxpayer is the safe-harbor lessor. In determining the credit carryback, tax liability for the taxable year from which credits are to be carried is reduced first by credits not allocable to safe-harbor leases, and no credit allocable to a safe-harbor lease may be carried back.

ACRS deductions

The Act lengthens the recovery period that applies to property in a safe-harbor lease to 5 years for 3-year property, 8 years for 5-year property, and 15 years for 10-year property. Cost recovery allowances are determined over the appropriate recovery period by applying prescribed percentages to the unadjusted basis of the property (as reduced for investment credits in accordance with the basis adjustment rules provided by the Act). These percentages, which are based on the use of a half-year convention in the first recovery year, the 150-percent declining balance method in early recovery years and the straight-line method in the remaining recovery years, are as follows:

If the recovery year is:	The applicable percentage for the class of property is:		
	3-year	5-year	10-year
1	15	9	5
2	25	17	10
3	20	14	9
4	20	12	8
5	20	12	7
6		12	7
7		12	6
8		12	6
9			6
10			6
11			6
12			6
13			6
14			6
15			6

Investment tax credit spread

Under the Act, only 20 percent of an investment credit earned for property subject to a safe-harbor lease is allowable in the first taxable year, and 20 percent of the credit is allowable in each of the four succeeding taxable years. This five-year spread of investment credits is required whether the taxpayer elects a 2-percentage-point reduction in the regular credit or makes a basis adjustment for that credit. The basis adjustment for an investment credit for property subject to a safe-harbor lease follows the general rule—that is, the basis adjustment for 50 percent of the full investment credit occurs in the first taxable year—notwithstanding the five-year spread of the credit applicable to such property. If the credit is passed through to the lessee pursuant to an election under section 48(d), the lessee must spread the credit over five years. For purposes of determining the order in which credits may be used, the portion of the credit earned but not allowable in the first taxable year is treated as an unused credit carried over from the first taxable year. Thus, in the taxable year it is first allowable, this portion carried over is applied against the investment credit tax liability limitation before credits earned for that year.

Maximum interest rate

The Act generally reduces the maximum rate of interest allowed on obligations of the lessor (or a person related to the lessor) to the lessee (or a person related to the lessee) in a safe-harbor sale-leaseback. For the purpose of determining the lessor's interest deductions from the agreement, this rate of interest cannot exceed the interest rate applicable to underpayments and overpayments of tax at the time the agreement was entered into. This interest rate limitation does not apply to a safe-harbor lease where there is no lessee financing. For purposes of this provision, the definition of a related person is the same as under section 168(e)(4)(D).

Related person transactions

The Act also prevents the lessee from entering into a safe-harbor lease with a related person. For this purpose, persons are related if they are part of an affiliated group as defined in section 1504, even if the persons are not "includible corporations" (as defined in section 1504(b)) and even though the group does not file a consolidated return.

ITC strip

The Act allows safe-harbor lease treatment for transactions referred to as lease-leasebacks or ITC strips entered into before October 20, 1981, which is the date Treasury issued its temporary regulations dealing with the safe-harbor provisions. An ITC strip is intended to permit the lessee to transfer the investment credit only. The Act does not alter the ability of the parties to structure a lease outside of the safe harbor so that the lessee retains the investment credit and the lessor the depreciation deductions (sec. 48(d)).

Closely held lessors

In general, the Act provides that under certain circumstances a closely held lessor will be considered at risk under section 465 with respect to qualified leased property for which a safe-harbor election is in effect in an amount equal to the at-risk investment of the lessee. If the lessee is not a person described in section 465(a)(1), and thus not a person subject to the at-risk limits, the closely held lessor will be considered fully at-risk. The provision applies only if the lessee would, without regard to the safe harbor rules, be considered the owner of the property.

Because a taxpayer's at-risk amount for purposes of the limitation on investment credits under section 46(c)(8) generally is the taxpayer's at-risk amount under section 465(b), the provision affects the at-risk limit on both losses and credits.

The provision does not apply to a corporation, the principal function of which is the performance of services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, athletics, or consulting.

Effective dates for safe harbor lease provisions

General rule

The modifications to the safe-harbor lease rules, in general, apply if either the lease is entered into or the property is placed in service after July 1, 1982. For this purpose (and for purposes of the transitional rules described below), the property is considered placed in service when placed in a state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity ("actual placed-in-service rule").[1]

Anti-abuse rules

The limitation on a lessee's percentage depletion deductions and the limitation on related party transactions apply to leases entered into after February 19, 1982.

Closely held lessors

The provision relating to the at-risk limits on closely held lessors generally applies to property placed in service after September 3, 1982, the date of enactment. The provision applies even if the property is otherwise excluded from the safe-harbor lease changes because it is transitional safe-harbor lease property (described below) or it is a mass commuting vehicle covered by a transitional rule. In addition, the provision applies to property placed in service on or before September 3, 1982,[2] if the lessor with respect to the property first becomes a closely-held corporation after September 3, 1982. For purposes of applying the effective date for this provision, property is considered placed in service no earlier than when the parties enter into the lease agreement ("deemed placed-in-service rule").[3]

Transitional safe-harbor lease property

General rule.—The modifications made by the Act do not apply to transitional safe-harbor lease property. In general, transitional safe-harbor lease property is property placed in service before January 1, 1983, if after December 31, 1980, and before July 2, 1982, (1) the lessee entered into a binding contract to acquire or construct the property, (2) the property was acquired by the lessee or (3) construction was commenced by or for the lessee.

A contract that limits damages to a specified amount (e.g., by a liquidated damages clause) is not considered binding unless the lessee may be liable for damages in an amount equal to at least 5 percent of the cost of the property.

---

[1] *See* Treas. Reg. § 1.46-3(d)(1)(i), (2).

[2] The Technical Corrections Act of 1982 added language to clarify that the provision applies even if the property is placed in service before July 1, 1982, the general effective date.

[3] This deemed placed-in-service rule generally applies for safe-harbor leases for all purposes of the Internal Revenue Code. The at-risk effective date rule is contained in a Code provision, unlike the general effective date and transitional rules, which are non-Code statutory provisions. Thus, the deemed placed-in-service rule applies, rather than the actual placed-in-service rule applicable to the general effective date and transitional rules.

For the transitional rule, the actual placed-in-service date (described above) applies.

In addition to property that meets this general rule, transitional safe-harbor lease property includes property described under one of the categories described below.

Aircraft.—Transitional safe-harbor lease property includes commercial passenger aircraft (other than helicopters) placed in service before January 1, 1984, if after June 25, 1981, and before February 20, 1982, either (1) the property was acquired by the lessee or construction was commenced by or for the lessee.

For this purpose, construction is considered to have commenced if construction or reconstruction of a subassembly was commenced or the stub wing join occurred. Construction of a subassembly means the joining of two or more separate parts to form an assembly by welding, riveting, bolting, or by other standard fastening methods in airframe or engine manufacturing procedures, including but not limited to bonding of fiberglass or graphite composites. Subassemblies may be built singly or in lot increments. The stub wing join occurs when the center wing section of the aircraft is joined with the right- and left-hand wings.

Auto manufacturing property.—Transitional safe-harbor lease property includes certain automobile manufacturing property placed in service before July 1, 1982, and leased before August 15, 1982.[4] In addition, it includes automobile manufacturing property that would meet the requirements of the general transitional rule above if October 1, 1983, were substituted for the January 1, 1983, placed-in-service date.

Steel.—Transitional safe-harbor lease property includes property used by the taxpayer directly in connection with the trade or business of the manufacture or production of steel that would meet the requirements of the general transitional rule if January 1, 1984, were substituted for the January 1, 1983, placed-in-service date. Property that is not used directly in connection with the production or manufacture of steel does not qualify for this rule.

Boilers and turbines of rural electric cooperatives.—Transitional safe-harbor lease property includes turbines and boilers of certain cooperative organizations. Congress intended that this provision apply only to cooperative organizations engaged in furnishing electric energy to persons in rural areas.[5] To qualify, the property must be property that would be transitional safe-harbor lease property by substituting July 1, 1983, for the January 1, 1983, placed-in-service date. For purposes of determining under this rule whether a boiler or turbine would be transitional safe-harbor lease property, the property will be considered acquired during the period between

---

[4] The Technical Corrections Act of 1982 clarifies the type of property eligible under the provision by referring to property used principally by the taxpayer directly in connection with the trade or business of manufacturing automobiles or light-duty trucks, and which is equipment, machinery, or tools of the type included in the former ADR classification for motor vehicles (including property owned by an automobile manufacturer and used by a vendor solely for the production of component parts to be sold to such manufacturer for inclusion in the finished automobiles or trucks.

[5] The Technical Corrections Act of 1982 add language which explicitly states that cooperatives to which the provision applies must be engaged in the furnishing of electric energy to persons in rural areas.

December 31, 1980, and July 2, 1982, if at least 20 percent of the cost of such property was paid during that period.

Property-by-property determination.—The transitional rules are applied for each separate item of property. For example, construction of a machine that will be placed in service in a plant commences when physical work on that machine begins. Commencement of construction of the machine is not considered to be commencement of construction of any other property in the plant. Similarly, the transitional rules regarding acquisitions and binding contracts apply for each separate unit of property.

Definition of construction.—For purposes of the transitional rules, construction is considered to have commenced when physical work on construction of the property commences. Physical work does not include planning, research, design, engineering studies, securing financing, test drilling, or any other activity that does not involve physical work. Clearing land for a separate item of property constitutes commencement of physical work on construction for that property.

Mass commuting vehicles

In general, the modifications to the safe-harbor lease provisions do not apply to mass commuting vehicles placed in service before January 1, 1988.

In addition, these modifications do not apply to a mass commuting vehicle placed in service after December 31, 1987, if (1) the property was not placed in service before January 1, 1988, solely because of conditions that are not within the control of the lessor or lessee, and (2) the property was placed in service pursuant to a binding contract or commitment entered into before April 1, 1983. For purposes of the transitional rule, a binding commitment includes bids that have been accepted by the transit system but that may be challenged by third parties. Change orders that do not affect the substance of a contract or commitment are permitted.

Under an exception to the general rule that the modifications to the safe-harbor lease provisions do not apply to mass commuting vehicles that meet one of the requirements described above, the lessor cap on tax liability imposed by the Act applies to a mass commuting vehicle that is not also transitional safe-harbor lease property as described above.[6]

Repeal

The Act repeals the safe-harbor lease provisions for leases (other than for leases covered by a transitional rule) entered into after December 31, 1983.

---

[6] Pursuant to the Technical Corrections Act of 1982, the provision relating to at-risk limits on closely-held lessors applies to mass commuting vehicles covered by this transitional rule if the effective date requirements of the at-risk change described above are met.

b. Changes to non-safe harbor leasing rules

Overview

Beginning in 1984, after the repeal of safe-harbor leasing, the Act liberalizes the non-safe harbor lease rules for a new category of property referred to as finance lease property. In addition to the changes with respect to finance lease property, the Act modifies the non-safe harbor lease rules for all property by permitting a 3-month window period to apply in determining whether property is new property in the hands of the lessor.

These rules generally apply to leases entered into after December 31, 1983. However, the finance lease rules apply to leases entered into after July 1, 1982, for up to $150,000 of a lessee's farm property.

The Act also prevents the IRS from retroactively denying lease treatment to motor vehicle leases that contain terminal rental adjustment clauses, provided that the property is used for business purposes and is not financed with nonrecourse debt.

Finance leases

Under the non-safe harbor lease rules for finance lease property, the fact that the lessee has a 10-percent fixed price purchase option or that the property is limited use property shall not be taken into account in determining whether the agreement is a lease.

A 10-percent fixed price purchase option means an option of the lessee (i.e., a call option) to purchase the property at the end of the lease for an amount fixed at the beginning of the lease at an amount that is not less than 10 percent of the original cost of the property to the lessor. Limited use property is property readily usable only by the lessee.

For 1984 and 1985, a lessor cap, a lessee cap, and an ITC spread (similar to limitations imposed on safe-harbor leases under the Act) apply for finance lease property.

No election of finance lease treatment is required for qualified agreements with respect to finance lease property. However, if the agreement is not a qualified agreement or the property is not finance lease property, the treatment of the transaction is determined under prior law without regard to these provisions of the Act.

In general, the finance lease provisions apply to leases entered into after December 31, 1983. However, the finance lease provisions apply after July 1, 1982, for leases of up to $150,000 of a lessee's farm property.

Finance lease property

In general, finance lease property is recovery property (as defined in section 168(c)) that is subject to a qualified agreement (described below) and that meets the requirements imposed in the following two situations.

First, for a transaction other than a sale-leaseback, finance lease property must be new section 38 property placed in service by the lessor and leased within 3 months after the lessor placed the property in service. To be new section 38 property, the original use of the property must commence with the lessor.

Second, in a sale-leaseback transaction, finance lease property must be new section 38 property when acquired by the lessee. The sale and leaseback must occur within 3 months after the lessee placed the property in service. The adjusted basis to the lessor must not exceed the adjusted basis to the lessee.

For purposes of determining whether property is finance lease property, the term "placed in service" generally means the time when the property is placed in a state of readiness and availability for a specifically assigned function, whether in a trade or business in the production of income, in a tax-exempt activity or in a personal activity (actual placed-in-service rule).[7]

Property excluded from the safe-harbor lease provisions (as revised by the Act) is also excluded from the finance lease provisions. For example, finance lease property does not include public utility property (as defined in section 167(1)(3)(A)), or property used by former tax-exempt organizations (other than property used in an unrelated trade or business the income from which is subject to tax under section 511 or property used by a farmer's cooperative described in section 521). Unlike the safe-harbor lease provisions, mass commuting vehicles are ineligible for finance lease treatment.

Qualified agreement

To be finance lease property, the property must be subject to an agreement characterized by the parties as a lease for Federal income tax purposes although no election is required. The lessor under the agreement must be a corporation, partnership of corporations, or a grantor trust all beneficiaries of which are corporations. The agreement must either contain a 10-percent fixed price purchase option or apply with respect to limited use property, or both.

The agreement must be a lease determined without taking into account the fact that it contains a fixed price purchase option or that the property is limited use property. Thus, the transaction must have economic substance independent of tax benefits. The lessor must reasonably expect to derive a profit independent of tax benefits. In addition, the transaction must not (without taking into account the fact the agreement contains a fixed price purchase option or that the property is limited use property) otherwise be considered a financing arrangement or conditional sale.

---

[7] *See*. Treas. Reg. § 1.46-3(d)(1)(ii), 2. However, for all other purposes of the Internal Revenue Code (such as determining whether the property is new property for investment credit purposes or for determining the time when depreciation and investment credit may be claimed), finance lease property is considered placed in service not earlier than when it is used under the lease ("deemed placed-in-service rule"). (Sec. 168(f) (8) (B) (vii) (III)).

Investment tax credit spread

The Act provides that only 20 percent of an investment credit earned for property subject to a finance lease is allowable in the first taxable year, and 20 percent of the credit is allowable in each of the four succeeding years. This provision operates in the same way as the provision relating to the 5-year spread of investment credits for safe-harbor lease property. The provision does not apply to property placed in service after September 30, 1985.

Lessor cap on current tax liability

The Act provides a 50-percent limit on the amount by which a lessor can reduce its income tax liability (including any liability under the add-on minimum tax) through finance leasing in taxable years ending after December 31, 1983 (lessor cap). Under these limitations, a lessor's tax liability is the greater of (1) 50 percent of the liability computed without regard to rental income, deductions and investment credits taken into account for the taxable year pursuant to a finance lease (finance lease items), or (2) the taxpayer's liability computed with regard to those finance lease items. Under regulations prescribed by the Secretary, safe-harbor lease items are taken into account in applying this limit such that the combined effects of safe-harbor leasing and finance leasing do not reduce a lessor's tax liability by more than 50 percent.

When tax liability is determined by operation of the 50-percent limitation, deductions or credits from finance leases are not allowable in the current taxable year to the extent they reduce the lessor's tax liability below the proper amount of tax determined under the lessor cap. Such deductions or credits may be carried forward, and shall be treated as allocable to finance lease property in the taxable year to which they are carried. The Secretary shall prescribe regulations for determining what deductions or credits are allowable in the current year and what deductions or credits must be carried forward.

This 50-percent limitation does not apply to property placed in service after September 30, 1985, in taxable years beginning after that date.

Lessee limitations

Lessee cap on amount of eligible property.—The Act imposes a 40-percent limit on the amount of a lessee's "qualified base property" that may be treated as finance lease property during any calendar year. Qualified base property for this purpose means property placed in service during the calendar year that falls within any one of the following mutually exclusive categories of property: (1) new section 38 property that is considered to be owned by the lessee; (2) finance lease property leased to the lessee; or (3) designated leased property leased to the lessee. Designated leased property generally has the same meaning given that term in the lessee cap applicable to safe-harbor leases under the Act. Thus, in general, designated leased property means new section 38 property that is considered to be owned by the lessor (without regard to the finance lease provisions) and leased for a term that is more than 50 percent of the ADR midpoint life of the property (or, more than 50 percent of the recovery period of the property if it has no ADR life). The lessee cap does not apply for property placed in service after calendar year 1985.

Limitation on lessee's percentage depletion.—The Act limits the ability of a lessee to increase its percentage depletion through the use of finance leasing. The lessee must compute its 50-precent and 65-percent taxable income limitations on percentage depletion deductions as if it were the owner of the property. Thus, for this purpose, the lessee must take into account ACRS deductions for the property and must disregard lease rentals. In computing the imputed ACRS deductions for the property, the lessee must use the regular ACRS deductions set forth in section 168(b)(1).

Related party transactions

The finance lease rules do not apply to transactions between related persons. For this purpose, persons are related if they are part of an affiliated group as defined in section 1504 even if the persons are not includible corporations (as defined in section 1504(b)) and even through the group does not file a consolidated return.

Farm finance leases

The finance lease provisions apply after July 1, 1982, for leases of up to $150,000 of a lessee's farm property. To be eligible, the cost basis of the property subject to the agreement must not, when added to the cost basis of farm property subject to a finance lease agreement entered into earlier in the taxable year by the lessee (or a related person), exceed $150,000.

For example, if a lessee buys two tractors each for $100,000, finance lease treatment is available only for the first tractor placed in service. Because the cost of the second tractor when added to the cost of the first tractor exceeds $150,000, no portion of the cost of the second tractor is eligible for finance lease treatment.

For this purpose, the definition of a related person in section 168(e)(4)(D) applies, except that an individual is not considered related to the lessee if the property is used in a trade or business of farming that is separate from the trade or business of farming of the lessee.

Other non-safe harbor lease rules unaffected

Except for the provision described below permitting a 3-month window for all leases, the Act does not affect the treatment of non-safe harbor leases that do not involve finance lease property. For example, a lease agreement that does not contain a fixed price purchase option and that does not involve limited use property is not subject to the lessor cap, lessee cap, or ITC spread imposed on a lease of finance lease property. Similarly, the treatment of an agreement that contains a fixed price purchase option but that does not otherwise meet the requirements for a qualified agreement (and the treatment of an agreement that does not apply to finance lease property) will be determined without regard to the provisions of the Act.

3-month window

In determining whether section 38 property subject to a lease is new section 38 property for purposes of the investment credit, the Act provides that the property is considered originally placed in service not earlier than the time it is used under the lease, if leased within 3 months after the actual place-in-service date as described above.

Terminal rental adjustment clauses

The Act prevents the IRS from retroactively denying lease treatment for certain motor vehicle leases, including leases of trailers, by reason of the fact that those leases contain terminal rental adjustment clauses that require or permit the rent to be adjusted upward or downward by reference to an amount realized by the lessor upon sale or other disposition of the property. The Act does not address the legal effect of these clauses and does not prevent the Treasury from issuing regulations on a prospective basis addressing the legal effect of these clauses.

The provisions of the Act regarding terminal rental adjustment clauses apply only to operating leases in which the lessee uses the property for business, as opposed to personal, purposes. For this purpose, a lease is an operating lease if the lessor acquires the property with cash or recourse indebtedness. Thus, the provision does not apply to leveraged leases financed with nonrecourse debt.

Effective dates for non-safe harbor leasing provisions

The finance lease provisions generally apply to leases entered into after December 31, 1983. However, for farm finance leases of up to $150,000, the provisions apply for leases entered into after July 1, 1982.

The provision permitting a 3-month window for all leases applies to property placed in service after December 31, 1983.

The provision relating to motor vehicle leases applies to any open taxable years.

Revenue Effect

The leasing provisions are expected to increase fiscal year budget receipts by $1,036 million in 1983, $2,649 million in 1984, $4,252 million in 1985, $5,496 million in 1986, and $7,000 million in 1987.

7. Foreign Tax Provisions

a. Limitation on credit for foreign income taxes imposed on foreign oil extraction income and current taxation of foreign oil-related income (secs. 211 and 212 of the Act and secs. 904, 907 and 954 of the Code)[*]

Prior Law

Foreign tax credit

The foreign tax credit was enacted to prevent U.S. taxpayers from being taxed twice on their foreign income—once by the foreign country where the income is earned and again by the United States as part of the taxpayer's worldwide income. The foreign tax credit is intended to allow U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid to a foreign country. Foreign tax credits may not be used to offset U.S. tax on domestic income.

The credit is available only with respect to foreign income, war profits, or excess profits taxes and certain "in lieu of" taxes (for ease of reference, referred to generally as foreign income taxes). Other taxes paid by the taxpayer are generally not creditable but are treated only as deductible expenses.[1]

A fundamental premise of the foreign tax credit is that it should not offset the U.S. tax on U.S. source income. Accordingly, the computation of the foreign tax credit provides for a limitation to ensure that the credit offsets the U.S. tax on only the taxpayers' foreign income. The limitation operates by prorating the taxpayer's total U.S. tax liability before foreign tax credits ("pre-credit U.S. tax") between his U.S. and foreign source taxable income. The limitation is determined by using a simple ratio of foreign source taxable income divided by total worldwide taxable income. The resulting fraction is multiplied by the total pre-credit U.S. tax to establish the amount of U.S. taxes that, absent a foreign tax credit, would be paid on the foreign income and, thus, the upper limit on the foreign tax credit.

Prior law provided that a taxpayer was to compute the foreign tax credit limitation on a worldwide basis separately for his foreign oil-related income.[2] Thus, foreign taxes paid on the taxpayer's foreign oil-related income could not offset his U.S. tax on his other income and vice versa. A similar rule is applied with regard to certain interest income and DISC dividends. In general, the foreign tax credit limitation must be computed separately for passive interest income and for dividends from a DISC.

---

[*] For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, secs. 216 and 217; S. Rep. No. 97-494 (vol. 1) (July 12, 1982), pp. 146-154; H. Rep. No. 97-760 (August 17, 1982), pp. 501-503; H. Con. Res. 398, 128 Cong. Rec. H6636 (daily ed. August 19, 1982). Also, see H.R. 6056, House floor amendments, 128 Cong. Rec. H9600-9604 (December 13, 1982); H. Rep. No. 97-986 (December 21, 1982), p. 28 (Joint Explanatory Statement of the Committee of Conference).

[1] No inference should be drawn from the Act, its legislative history, or this explanation that Congress agrees or disagrees that any particular payments to foreign governments are properly treated as income taxes.

An additional special limitation is placed on foreign income taxes on income from oil and gas extraction (section 907, added to the Code in 1975 and later amended). Under this special limitation, amounts claimed as taxes paid on foreign oil and gas extraction income of a U.S. company qualify as creditable taxes (if they otherwise so qualify) only to the extent they do not exceed 46 percent (the highest U.S. corporate tax rate) of such extraction income.[3] Foreign taxes paid in excess of that amount on such income are, in general, neither creditable nor deductible. However, a foreign tax credit carryover or carryback was allowed for excess extraction taxes paid to the extent of 2 percent of foreign oil extraction income.

The taxpayer's foreign extraction income is generally the sum total of the taxpayer's income and loss from worldwide foreign extraction operations. However, under prior law, if the extraction activities and the sales of extraction assets in any single country resulted in a net loss for any year, the loss from that country was not taken into account in the computation of the foreign oil extraction income for the year. This special rule was referred to as the "per-country extraction loss rule" (sec. 907(c)(4)). It had the effect of increasing a taxpayer's oil and gas extraction tax limitation by 46 percent of the nonincluded loss, which in turn generally increased the amount of oil and gas extraction taxes that the taxpayer could treat as creditable taxes. The per-country extraction loss was included, however, in computing the taxpayer's overall foreign tax credit limitation for foreign oil-related income for the year.

The effect of the per-country extraction loss rule was to allow a company to use foreign oil extraction tax credits not only against foreign extraction income, but also, in certain cases, against low-taxed non-extraction foreign oil-related trading, refining or shipping income. This occurred because foreign oil extraction income was not computed on a worldwide basis where there was a net loss in any country. To illustrate, if a company's extraction activities had generated $300 income in country A on which it had paid $138 of foreign income tax, and a $100 loss in country B, it would have had net income of $200 from those foreign extraction activities on which it would have paid $92 of U.S. tax (at a 46-percent rate) before the foreign tax credit. However, because the $100 loss would not have been taken into account in computing the 46-percent extraction limitation under prior law, the company could have been entitled to claim oil tax credits of $138 (46 percent of $300)—using $92 in credits against the U.S. tax on the net extraction income and the $46 excess credits against other oil-related income. The use of $46 of extraction tax credits to reduce U.S. tax on other oil related income was generated only as a result of the per-country extraction loss rule.

---

[2] The term "foreign oil-related income" included the income derived from sources outside the United States and its possessions from the extraction (by the taxpayer or any other person) of minerals from oil or gas wells, the processing of these minerals into their primary products, and the transportation, distribution, and sale of these minerals or primary products. The term also included income from the sale or exchange of assets used in these activities. Finally, the term included certain other income indirectly derived from these activities: in general, dividends (including deemed dividends under subpart F) and interest from foreign corporations in which the taxpayer had a 10-percent stock interest, foreign source dividends from a U.S. corporation, and the taxpayer's distributive share of the income of partnerships, to the extent the dividends, interest, or distributive share was attributable to foreign oil-related income of the intermediate corporation or partnership.

[3] For purposes of this limitation, "foreign oil and gas extraction income" is the foreign source taxable income from extraction of minerals from oil and gas wells or from the sale of extraction assets. The term also includes certain other indirect income derived from these activities.

If a taxpayer sustains an overall foreign loss in any taxable year, the taxpayer in succeeding taxable years must generally treat foreign source taxable income as U.S. source income in an amount which is equal to the lesser of (1) the remaining balance of the overall foreign loss, or (2) 50% of the taxpayer's taxable income from foreign sources for the succeeding taxable year in question. (Section 904(f), added to the Code in 1976.) The overall foreign loss had to be determined separately for foreign oil and non-oil related income.

Subpart F income

The United States subjects to tax the worldwide income of any corporation organized under the laws of the United States. However, foreign corporations (even those that are subsidiaries of U.S. companies) generally are taxed by the United States only to the extent they earn income from a business in the United States or derive investment income here. As a result, the United States usually does not impose a tax on the foreign source income of a foreign corporation even though it is owned or controlled by U.S. persons. Instead, the foreign source earnings of a foreign corporation generally are subject to U.S. income taxes only when and if they are actually remitted to U.S. shareholders as dividends. The tax in this case is imposed on the U.S. shareholder and not the foreign corporation. U.S. tax on the dividend income may be offset by foreign tax credits.

An exception to the general rule is provided for certain "tax haven" base company type activities of controlled foreign corporations (sec. 951). These are foreign corporations more than 50 percent of the stock of which is owned by U.S. shareholders each of which owns at least 10 percent of the corporation's stock. The U.S. shareholders of these corporations are taxed under the subpart F provisions of the Code. Under these provisions, certain earnings and profits of the controlled foreign corporation ("subpart F income") are deemed to be distributed to the U.S. shareholders, and are subject to taxation currently whether or not the shareholders actually receive the income in the form of a dividend.

There were five categories of subpart F income taxed currently to U.S. shareholders of controlled foreign corporations: (1) income from the insurance of U.S. risks; (2) passive investment income such as dividends, interest, royalties, and rents; (3) sales income earned by the foreign subsidiary on the sale of property purchased from, or sold to, a related company if the property was neither manufactured in nor sold for use in the country in which the subsidiary is incorporated; (4) income from services performed for or on behalf of a related person by the foreign subsidiary outside of the country in which it is incorporated; and (5) shipping income earned by a foreign subsidiary outside of the country in which it is incorporated, if that income is not reinvested in shipping assets.

Reasons for Change

Foreign tax credit

The Code has been amended in recent years to restrict further the foreign tax credit limitation in cases where the amount of foreign source income could be manipulated for tax purposes and in cases where certain types of income often bear a rate of tax which is abnormally high or in excess of rates on other types of income.[4] These further limitations segregate different types of income, such as certain passive interest income or oil-related income, and attempt to permit foreign taxes on only the segregated type of income to be credited against U.S. tax on that type of income. Taxes on foreign oil and gas extraction income, under one of these rules, are generally intended to be creditable only against U.S. tax on foreign oil and gas extraction income, and not against U.S. tax on low-taxed, non-extraction trading, refining, shipping or non-oil-related income.

Congress concluded that the special per country extraction loss rule prevented the effective application of the special rule segregating oil and gas extraction income. By allowing extraction losses incurred in one country not to offset extraction income in another, creditable extraction taxes were overstated. This overstatement permitted foreign taxes on extraction income to offset U.S. tax on foreign income from non-extraction sources, contrary to the general goal of segregating oil and gas extraction income and taxes.

Accordingly, Congress believed it appropriate to repeal the special per country extraction loss rule in order to limit the amount of creditable extraction taxes to no more than the taxpayer's U.S. tax on extraction income. In this manner Congress intended to assure that high-rate foreign taxes on extraction income could not be used to offset U.S. tax liability on other foreign source income subject to a low rate of foreign tax.

Congress believed that the separate foreign tax credit limitation for foreign oil related income was no longer necessary. The purpose of that separate limitation was to prevent the use of excess credits from foreign oil related income against taxes on other kinds of income. The limits imposed by the Act on the use of excess credits from foreign oil related income remove the opportunities for use of such credits against taxes on other kinds of income. Therefore, Congress repealed that separate limitation.

---

[4] When U.S. oil companies began operations in a number of major oil exporting countries, they paid only a royalty for the oil extracted since there was generally no applicable income tax in those countries. However, in part because of the benefit to the oil companies of imposing an income tax, as opposed to a royalty, those countries have adopted taxes applicable to extraction income and have labeled them income taxes. Moreover, because of this relative advantage to the oil companies of paying income taxes rather than royalties, many oil-producing nations in the post-World II era have tended to increase their revenues from oil extraction by increasing their taxes on U.S. oil companies.

As the result of these increases in the effective tax rate, many oil-producing countries now impose taxes on oil income at effective rates as high as 80 percent or more, while the charges designated as royalties are imposed at relatively low rates (usually 20 percent or less) as compared to the generally applicable income taxes paid to those countries.

Congress believed it appropriate to permit overall extraction losses in excess of overall extraction income to offset other income. However, Congress also believed it appropriate to, in effect, recapture these losses so that timing differences would not prevent effective application of the special extraction tax limitation.

Subpart F income

In addition to extraction income, multinational oil companies earn significant revenues from so-called downstream activities such as the transportation, shipping, refining, trading and retail sale of petroleum. Prior to 1975, the multinational oil companies had unfettered discretion to offset tax on their downstream income (often earned in low tax countries) with credits from high extraction taxes. In addition, they were able to use foreign losses to offset U.S. income.

Even with the changes made in 1975 and succeeding years that limited the opportunity to use excess credits to shelter non-extraction income, multinational oil companies had paid relatively little U.S. tax on their foreign operations. In part, this was due to the special per country extraction loss rule, which provided that in computing the 46-percent limitation on extraction taxes, extraction losses were not taken into account if they arose in a country for which the taxpayer had a net extraction loss for the year, and which this Act repeals (section 907(c)(4)). When the downstream activities were conducted in a foreign subsidiary, however, U.S. tax generally could be avoided even if foreign income taxes were not sufficient to shelter all of the foreign income, since income of a U.S.-controlled foreign subsidiary was not subject to U.S. tax until that income was paid to its shareholders. Also, because of the fungible nature of oil and because of the complex structures involved, oil income is particularly suited to tax haven type operations. In addition, because oil is fungible, downstream income can be manipulated—directly, if the taxpayer produced the oil, or indirectly, through swapping or similar practices. Therefore, Congress did not limit Subpart F treatment to oil income associated with oil produced by the taxpayer.

The net result has been that the petroleum companies have paid little or no U.S. tax on their foreign subsidiaries' operations despite their extremely high revenue. Congress believed that all integrated oil companies should pay U.S. tax on foreign oil related income earned in countries with taxes on that income below the U.S. rate. Accordingly, the Act applies the present law anti-tax haven provisions (subpart F) to tax currently certain low taxed foreign oil related income earned by foreign corporations controlled by U.S. persons. Congress recognized that international shipping, because it is highly competitive and is generally not taxed by other countries, presents special problems. Accordingly, Congress decided that the tax treatment of that income should not be changed without further study.

Explanation of Provisions

Repeal of the per-country extraction loss rule

The Act repeals the special per-country extraction loss rule. Accordingly, when a taxpayer has a net extraction loss from a country for a year, the loss from that country will be taken into account in the computation of the foreign oil extraction income of the taxpayer for the year. For example, if a company's extraction activities generated $300 income in country A, on which it paid $138 of foreign income tax, and a $100 loss in country B, it will have net income of $200 from those foreign extraction activities on which it would pay $92 of U.S. tax (at a 46 percent rate) before the foreign tax credit. Because the $100 loss would be taken into account in computing the 46 percent extraction limitation, the company would be entitled to claim oil tax credits of up to only $92 (46 percent of $200). Therefore, the taxpayer would use $92 in credits against U.S. tax on net extraction income and could not use any excess extraction credits against other income.

The present law definition of the term "foreign oil and gas extraction income" for purposes of the special foreign tax credit limitation is retained.

The Act provides that in cases where a taxpayer has an overall foreign extraction loss in a year that reduces nonextraction income, the loss is, in effect, to be recaptured in a subsequent year in which the taxpayer has overall foreign oil and gas extraction income. The recapture provision operates in substantially the same fashion as the overall foreign loss recapture provision in the Code (sec. 904(f)).

The loss recapture is accomplished by recharacterizing a portion of the foreign oil and gas extraction income earned in later years as foreign-source income that is not oil and gas extraction income. The amount of the foreign extraction income which is to be recharacterized as nonextraction income is equal to the amount of the extraction losses from prior post-1982 years, but only to the extent that the losses have not been recharacterized in such prior years. Recharacterization is to occur even though the taxpayer obtained no tax benefit from the loss.

For the purposes of this recapture provision, the term "overall foreign extraction loss" means the amount by which the taxpayer's (or in the case of an affiliated group filing a consolidated return, the group's) gross income from activities giving rise to foreign oil and gas extraction income is exceeded by the sum of the expenses, losses, and other deductions properly apportioned or allocated to that income and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income (under sec. 862(b) or 863 of the Code). If no overall foreign extraction loss has been sustained in the case of an affiliated group of corporations filing a consolidated return, then no such loss is subject to recapture under this provision even if a member of the group had an extraction loss and the member is subsequently sold or otherwise leaves the group. In computing the amount of the foreign extraction loss, the net operating loss deduction (under sec. 172(a)) is not to be taken into account. In addition, foreign expropriation losses (as defined in sec. 172(h)(1) of the Code) or an extraction loss which arises from fire, storm, shipwreck, or other casualty, or from theft (to the extent the loss is not compensated for by insurance or otherwise) are not subject to the recapture provision. A taxpayer is to be treated as sustaining a foreign extraction loss whether or not he claims a foreign tax credit for the year of the loss.

In cases where the taxpayer realizes an overall foreign loss, part or all of which is a foreign extraction loss, both the overall foreign loss recapture rule and the extraction loss recapture rule will apply. For example, if a company has an overall foreign extraction loss for a year of $100, $75 of other foreign income, and also $100 of U.S. income, the extraction loss first offsets the $75 of other foreign income and then offsets $25 of U.S. income. If in the subsequent year that company has $100 of foreign oil extraction income the prior year's overall foreign extraction loss would first recharacterize $25 of income as U.S. source income (sec. 904(f)) and would then recharacterize $75 of foreign oil extraction income as other foreign income. However, any foreign taxes imposed on the income that is recharacterized would not be recharacterized as anything other than extraction taxes; that is, extraction taxes always retain their character as extraction taxes.

The separate foreign tax credit limitation for oil and gas income is repealed and the general foreign tax credit rules and the overall limitation of the Code apply to oil and gas related income. The Act contains, however, a special rule to prevent the immediate recapture of non-oil related overall foreign losses. For this purpose, this special rule maintains the distinction between non-oil related and oil related overall foreign losses incurred in taxable years beginning on or before January 1, 1983, and subject to recapture in taxable years beginning after December 31, 1982. However, in order to assure that this special rule does not have an indefinite life, a provision to phase-in the recapture of any pre-1983 overall foreign non-oil related losses over a period of 8 years (generally, at a rate of 12½% a year) has been included in the Act. This special rule provides that in computing the recapture of an overall foreign non-oil related loss incurred in a taxable year beginning before 1983, the separate foreign tax credit limitation for non-oil related income as in effect under prior law will generally apply. However, for purposes of applying the foreign tax credit foreign loss recapture rules with respect to taxes paid or accrued in a taxable year beginning after December 31, 1982, an additional amount of pre-1983 non-oil related losses (in addition to the full amount of such losses recaptured under the separate limitation rule by virtue of post-1982 non-oil related income) will be recaptured. This additional amount shall at least be equal to the lesser of: (1) an amount equal to 12½% of such pre-1983 overall foreign non-oil related loss multiplied by the number of taxable years that have elapsed since December 31, 1982, but less the amounts (if any) previously recaptured under the 12½% rule; or (2) the taxpayer's taxable income from sources without the United States that is not recaptured under the separate limitation rule above.

The Technical Corrections Act of 1982, H.R. 6056, conforms the treatment of pre-TEFRA foreign oil related losses to the treatment of pre-TEFRA foreign non-oil related losses.Thus, it provides that a pre-TEFRA foreign loss from either of the two separate baskets (the foreign oil related basket and the foreign non-oil related basket) will be recaptured from post-TEFRA income from the other basket will be in addition to (and not in lieu of) recapture of losses ginning with the first taxable year beginning after December 31, 1982. Such recapture of losses against income from the other basket willb e in addition to (and not in lieu of) recapture of losses against income from the same basket.

While the Act limits substantially the foreign tax credit for taxes paid to foreign countries with respect to foreign oil and gas extraction income, foreign tax credits are still permitted, subject to the general rules and the overall limitation, for taxes paid with respect to non-extraction oil related income.

Under the Act, any foreign income taxes otherwise creditable under the Code which are paid or accrued to any foreign country with respect to foreign oil related income generally will be creditable against U.S. income taxes. Under a grant of regulatory authority, however, amounts are not creditable to the extent that the Secretary determines that the foreign law that imposes the tax is structured, or in fact operates, so that the amount imposed with respect to foreign oil related income will in most cases be materially greater than the amount generally imposed on income that is not oil-related income. The amount not treated as a creditable tax under this provision will be treated as a business expense. Accordingly, the excess amount will be deductible for purposes of computing an appropriate level of foreign income tax and for U.S. tax purposes.

In determining the amount of taxes which is creditable, the Secretary will take into account the deemed foreign law deduction for amounts treated as excess payments under the provision when he recomputes the foreign tax paid. This is to assure that the rate of foreign tax on the oil profits after the deduction will not exceed the rate of tax generally imposed by the country on other income. This amount must be computed by the use of simultaneous equations.

For example, assume a foreign country has a generally applicable income tax of 40 percent but imposes an additional "tax" on oil related income which results in a total of 55 percent. A company earning $100 of oil related income on which it paid oil "taxes" of $55 will, for purposes of computing the amount creditable as a foreign income tax, treat $25 of that payment as a deductible excess payment, leaving U.S. taxable income and foreign law taxable income for purposes of this computation of $75. The company will be entitled to treat the remaining $30 of the foreign tax as a credit against the $34.50 precredit U.S. tax on that $75 taxable income—leaving a net U.S. tax liability of $4.50. The amount of the foreign tax allowed as a credit ($30) will be 40 percent (the generally applicable tax rate of that country) of the $75 net taxable income from that country.

The present law definition of foreign oil related income generally is retained under the Act. However, foreign oil extraction income is excluded and related services income is included.

The provision contains special rules for the carryover of certain oil taxes. These rules provide that credits available for carryover from pre-enactment years to post-enactment years are calculated by applying the rules in effect before the date of enactment. That is, the separate characterization of credits carried over to post-enactment years as oil-related or non-oil-related will be maintained. In the post-enactment year, the oil-related credits carried forward cannot be applied against the U.S. tax on non-oil-related income, and non-oil related credits carried forward cannot be applied against the U.S. tax on oil-related income. Thus, for example, in determining the amount of the carryovers to be applied against post-enactment taxes on income from post-enactment years, pre-enactment oil-related taxes available for carryover cannot be applied against taxes on income that would have been non-oil-related income under prior law. A similar rule is provided to limit carrybacks of taxes paid after 1982 to pre-enactment years.

The Act repeals the limitation (to 2 percent of foreign extraction income) on carrybacks and carryovers of excess foreign oil and gas extraction taxes. The 2 percent limitation (as well as the separate oil related income limitation) remains in effect, however, for carrybacks to taxable years beginning before January 1, 1983. Moreover, taxpayers may not carry forward to taxable years beginning on or after January 1, 1983, credits from taxable years beginning before that date in excess of the current 2 percent limitation.

The taxpayer may not use any excess foreign oil and gas extraction taxes carried over from years beginning on or after January 1, 1983, to offset U.S. tax on any nonextraction income, but only to offset U.S. tax on foreign oil and gas extraction income. Thus, these taxes retain their character as extraction taxes in any year in which they are deemed paid (sec. 904(c)).

Congress intended that the Department of the Treasury review the impact and effect of the foreign oil and gas tax credit provisions of the Act on multinational oil companies and report its conclusions to Congress by December 1, 1983.

Current taxation of foreign oil and gas related income of foreign subsidiaries

The Act generally imposes current U.S. tax on foreign oil related income earned by a controlled foreign corporation. This is accomplished by treating certain foreign oil related income as an additional category of foreign base company income currently included in the U.S. shareholder's income under subpart F. This additional category of income is called foreign base company oil related income.

Foreign base company oil related income includes income derived from sources outside the United States from the processing of minerals extracted (by the taxpayer or any other person) from oil or gas wells into their primary products and the distribution of oil or gas minerals or primary products. Income from the performance of services related to oil and gas extraction or oil related activities is oil related income if the person performing the services or a related person is engaged in oil and gas extraction activities. Thus, for example, income of a contract driller will not be foreign oil related income (or extraction income). Services include, for example, transportation of oil (other than foreign base company shipping income), accounting or managerial services, or insuring oil extraction or nonextraction assets. Foreign base company oil related income also includes the sale or exchange of an asset used by the taxpayer in a trade or business encompassing one of these activities.

Foreign base company oil related income also includes dividends and interest from a foreign corporation with respect to which taxes are deemed paid by the taxpayer, dividends from a domestic corporation which are treated as income from sources without the United States under the Internal Revenue Code, amounts with respect to which taxes are deemed paid under the present subpart F provisions of the Code, and the taxpayer's distributive share of the income of partnerships. These amounts are treated as foreign oil related income, however, only to the extent they are attributable to foreign oil related income. In addition, interest from a foreign corporation and dividends from a domestic corporation which are treated as foreign source are foreign base company oil related income to the extent attributable to foreign oil and gas extraction income. Thus, such interest and dividends are oil related income even though foreign oil and gas extraction income is not foreign base company oil related income.

Consistent with the base company concept, two exceptions to current taxation are provided. First, foreign oil related income derived from sources within a foreign country in connection with oil or gas which was extracted by anyone from an oil or gas well in that foreign country is not subject to the current taxation rules. For example, income derived in a foreign country by a subsidiary from the purchase and sale of oil extracted in that country is not treated as subpart F income. However, income the subsidiary derives from the purchase and sale in one country of oil extracted in a second country (for ultimate consumption in a third country) is subpart F income. Thus, if a controlled foreign corporation has income from refining in country A, and half of the income of the corporation is from refining oil extracted by the corporation in country A and half elsewhere, half of its income is not base company income. Second, foreign oil related income derived from sources within a foreign country in connection with oil, or gas, or a primary product of oil or gas which is sold by that foreign corporation or by a related person for use or consumption in that country is not subject to the current taxation rules. Fuel transferred into the fuel tank of a vessel or an aircraft (e.g., bunkers with respect to a vessel) for consumption by such vessel or aircraft is considered to be consumed in the country in which that transfer occurs.

In addition, the Act exempts the U.S. shareholder of a controlled foreign corporation from current tax if neither the controlled foreign corporation nor any related person (as defined in subpart F) has substantial foreign oil or gas extraction income. The exemption will apply if the aggregate average daily production of foreign crude oil and natural gas by the foreign corporation and related persons for the current or the preceding taxable year is less than 1000 barrels per day (or its equivalent in gas).

Shipping income which is foreign base company shipping income is not subject to current tax in the hands of U.S. shareholders as foreign base company oil related income. It will, however, continue to be subject to the provisions of subpart F relating to foreign base company shipping income.

The exception from foreign base company income in subpart F for foreign corporations not availed of to reduce taxes does not apply to foreign base company oil related income.

Effective Date

The provision generally applies to taxable years beginning on or after January 1, 1983, and to losses realized after that date. The provision relating to excess payments of foreign oil related taxes applies to payments made on or after January 1, 1983. The provision relating to current taxation of certain oil related income of foreign subsidiaries of U.S. oil companies applies to taxable years of foreign corporations beginning on or after January 1, 1983, and to taxable years of United States shareholders within which or with which such taxable years of foreign corporations end.

Revenue Effect

It is estimated that this provision will increase budget receipts by $200 million in fiscal year 1983, $438 million in 1984, $508 million in 1985, $569 million in 1986, and $621 million in 1987.

b. Possession tax credit; Income tax liability incurred to the Virgin Islands (sec. 213 of the Act and secs. 246, 367, 934, and 936 of the code)*

Prior Law

Overview

The possessions of the United States, including Puerto Rico, the U.S. Virgin Islands, Guam, and American Samoa, are subject to tax rules sometimes different from those generally in effect in the 50 States and the District of Columbia. Through some of these special rules, Congress has sought to encourage U.S. corporate investment in the possessions. Certain investment incentive programs established by the possessions have complemented the special Federal tax rules in inducing U.S. corporate investment.

Puerto Rico and the other possessions (except the Virgin Islands)

Section 936 of the Internal Revenue Code provides a special tax credit for certain income of certain U.S. corporations operating in Puerto Rico or other possessions of the United States, other than the Virgin Islands. This tax credit (called the section 936 credit) is given in lieu of the ordinary foreign tax credit provided in section 901 of the Code.

Any domestic corporation which elected to be a section 936 corporation could receive the section 936 tax credit if it satisfied two conditions. First, 80 percent or more of its gross income for the 3-year period or applicable part thereof immediately preceding the close of the taxable year had to be from sources within a possession (or possessions). Second, 50 percent or more of its gross income for that period had to be derived from the active conduct of a trade or business within a possession (or possessions).

A section 936 corporation is generally subject to tax on worldwide income in a manner similar to that applicable to any other U.S. corporation, but a full credit was given for the U.S. tax on the business and qualified investment income from possessions regardless of whether any tax had been paid to the governments of the possessions. The effect of this treatment was to exempt from tax the income from business activities and qualified investments in the possessions and the income from disposition of a possession business. All other income of section 936 corporations (with allowance for the usual foreign tax credit for foreign taxes paid with respect to foreign source income) was taxed currently.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 218; S. Rep. No. 97-494 (vol. 1) (July 12, 1982), pp. 155-163; Senate floor amendment, 128 Cong. Rec. S9017 (daily ed. July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 504-513.

Qualified possession source investment income includes only income from sources within a possession in which the possessions corporation actively conducts a trade or business (whether or not such business produces taxable income that taxable year). The taxpayer must establish to the satisfaction of the Secretary that the funds invested were derived from the active conduct of a trade or business within that same possession and were actually invested in assets in that possession. Income from sources within the possession attributable to reinvestments of qualified possession source investment income is also treated as qualified possession source investment income. Funds placed with an intermediary (such as a bank located in the possession) are treated as invested in that possession only if it can be shown that the intermediary did not reinvest the funds outside the possession.

To avoid a double credit against U.S. taxes if a corporation is eligible for the section 936 credit, any actual taxes paid to a foreign country or a possession with respect to the gross income taken into account for the credit are not treated as a creditable tax under section 901 of the Code, and no deduction is allowed with respect to that tax. Thus, the section 936 credit replaces entirely any regular foreign tax credit and any deduction for foreign income taxes paid which otherwise would be allowed with respect to the income taken into account.

Since the section 936 tax credit is separate from the tax credit permitted under section 901, and since most of a possessions corporation's income must be foreign source, the limitation under section 904 of the Code does not apply to income subject to a section 936 credit, and such income is not taken into account in computing the limitation on the amount of allowable tax credits (under sec. 904 of the Code).

The section 936 credit generally is allowed against taxes imposed by chapter 1 of the Internal Revenue Code. However, the credit is not available against any minimum tax for tax preferences (sec. 56 of the Code), any tax on accumulated earnings (sec. 531 of the Code), taxes relating to recoveries of foreign expropriation losses (sec. 1351 of the Code), or the personal holding company tax (sec. 541 of the Code). In computing the amount of U.S. tax paid by the corporation which is attributable to active trade or business in a possession and qualified investment income, taxes paid relating to the items described above are not taken into account.

An electing section 936 corporation cannot join in a consolidated U.S. tax return with related taxpayers. The election must remain in effect for 10 taxable years (so long as the corporation meets the income qualifications) unless the Secretary consents to revocation.

Dividends received from a section 936 corporation are eligible for the 100-percent dividends-received deduction or the 85-percent dividends-received deduction under section 243. No credit or deduction is allowed for income taxes paid to a possession or foreign country with respect to repatriation of the earnings of a section 936 corporation, however.

Puerto Rico generally has matched the United States' tax incentives with incentives of its own. Puerto Rico grants tax exemptions of up to 90 percent for income of certain approved enterprises for specified periods of time (generally 10 to 25 years). In addition, Puerto Rico exempts from income taxation certain passive income, such as interest on fixed-term deposits in qualifying banks, in the hands of certain companies to which it has granted investment incentives.

The U.S. Virgin Islands

Although the section 936 possession corporation rules do not apply in the Virgin Islands, a different set of rules provides similar tax incentives for U.S. investment there.

In the Virgin Islands, the U.S. Internal Revenue Code is generally applied as a local territorial tax code, except that tax proceeds are paid into the treasury of the Virgin Islands. In applying the Internal Revenue Code in the Virgin Islands, the name "Virgin Islands" is generally substituted for the name "United States" wherever it appears in the U.S. Code.

Corporate and individual "inhabitants" of the Virgin Islands satisfy their U.S. income tax obligations by paying tax to the Virgin Islands on their worldwide income, including U.S. source income. All corporations chartered in the Virgin Islands are considered to be "inhabitants" of the Virgin Islands. In certain circumstances a United States corporation may also qualify as an "inhabitant" of the Virgin Islands.

The United States subjects to tax dividends paid by a Virgin Islands ("V.I.") subsidiary to a U.S. parent. Dividends paid by a U.S. subsidiary that is a V.I. inhabitant to its U.S. parent qualify for the dividends received deduction under section 243.

The Internal Revenue Code limits the power of the Virgin Islands government to grant relief from its income tax (sec. 934). The Virgin Islands is prohibited from granting rebates for taxes attributable to income derived from sources within the United States. With respect to non-U.S. source income, the Virgin Islands was precluded from granting corporate tax rebates except to U.S. and V.I. corporations that had derived for the past 3 taxable years (or applicable part thereof) at least 80 percent of their gross income from V.I. sources and at least 50 percent of their gross income from the active conduct of a trade or business within the Virgin Islands (sec. 934). Acting within the constraint of this test, the Government of the Virgin Islands established further criteria for rebates of tax on V.I. source business income, such as a $50,000 minimum investment and certain employment criteria.

In effect, U.S. corporate inhabitants of the Virgin Islands could obtain tax benefits substantially similar to those available under section 936 for possessions corporations. However, unlike Puerto Rico, the Virgin Islands had not provided tax relief for interest income.

Reasons for Change

Overview

In connection with the Tax Reform Act of 1976, Congress directed the Department of the Treasury to report annually on the possessions corporation system of taxation. Treasury's three reports issued prior to passage of the Act confirmed the existence of two problems in that system: (1) unduly high revenue loss attributable to certain industries due to positions taken by certain taxpayers with respect to the allocations of intangible income among related parties, and (2) continued tax exemption of excessive possession source investment income.

Qualified possession source investment income

Treasury's third annual report, the latest issued to date, indicates that by the end of 1979, financial (as opposed to physical) investment of section 936 corporations in Puerto Rico amounted to some $4.6 billion, of which some $2.9 billion was in certificates of deposit in Puerto Rican banks.[1] These financial investments were generally subject to no U.S. or Puerto Rican tax. According to the third Treasury report, this benefit apparently did not greatly increase net capital flows into Puerto Rico over what they otherwise would have been. Funds which flowed into Puerto Rico through financial investments by section 936 corporations tended to flow out again through the banking system. Therefore, the exemption of qualified possession source investment income from U.S. tax apparently provided little net new capital to allow investors to acquire new plant and equipment. In fact, the exemption appeared to be permitting taxpayers to shelter significant amounts of passive income. Therefore, Congress believed that some limitation of the effective exemption of investment income was necessary.

Allocation of intangibles income

Under prior law, some taxpayers had taken the position that they could make tax-free transfers of intangible assets created or acquired in the United States (such as patents, secret processes, and trademarks) to an electing section 936 corporation, and that no allocation of income generated by those intangibles to the U.S. parent was required. The view of the Internal Revenue Service was that the Service had to make an allocation to the U.S. parent of all or a portion of the income attributable to the intangibles. This issue was before the U.S. Tax Court at the time the Act passed, and had created widespread uncertainty among taxpayers. It could take many more years before this issue is ultimately resolved by the judicial process.[2] Because a section 936 corporation is a domestic corporation, a ruling is not required to obtain tax-free treatment on the transfer.

For instance, a U.S. pharmaceutical company could spend (and deduct or amortize and take a research and development tax credit for) large sums on research and development of new drugs. When it developed an effective drug, it could transfer the patent on the drug and the know-how to manufacture the drug to a section 936 subsidiary in a purportedly tax-free exchange. Thereafter, the 936 company could manufacture the drug and claim for itself the ex-

---

[1] The Treasury report indicated that this accumulation of financial assets distorted the balance sheets of both banks and investing section 936 corporations. The $2.9 billion of bank deposits by possessions corporations at the end of 1979 constituted some 34 percent of all deposits in Puerto Rican banks. At the end of 1978, retained earnings represented 77 percent of total liabilities and shareholders' equity of all manufacturing possessions corporations. The comparable figure for all U.S. manufacturing corporations was approximately 40 percent.

[2] No inference should be drawn from the Act, its legislative history, or this explanation that Congress agrees or disagrees with either the taxpayers involved or the Internal Revenue Service about this issue.

BEST COPY AVAILABLE

tremely high profits which typically result from the sale of pharmaceutical products. It was Congress' understanding that high profits on certain pharmaceutical products must be realized because, according to the industry, the profits from the relatively few successful drugs must, in effect, amortize the development costs of all the unsuccessful products and finance the necessary research and development for future products. This results in the creation of extremely valuable intangibles (e.g., patents and trademarks) in the drug industry. If there is no allocation of income from the intangibles to their developer (the U.S. parent), a distortion of income results, with the parent obtaining deductions for its efforts while the 936 company realizes tax-free income.

The Treasury Department's annual reports have documented the cost of increased Puerto Rican employment in terms of U.S. revenue loss from section 936. While the possession credit has attracted Puerto Rican investment that has increased employment, the revenue cost per affected employee is greater than average wages paid, particularly in intangible intensive industries. For example, in 1978, the Federal tax expenditure per Puerto Rican employee averaged $12,667 in all manufacturing industries as compared with an average compensation of possessions corporation employees of $10,667. In intangible intensive industries, such as pharmaceuticals, the tax expenditure in 1978 averaged $43,261 as compared to an average employee compensation of $13,618. For nine particular Puerto Rican possessions corporations, the tax expenditure per employee exceeded $100,000 in 1978. In 1978, 50 percent of the total tax expenditure was attributable to the pharmaceutical industry which accounted for only 15 percent of all Puerto Rican manufacturing jobs or approximately 3 percent of total Puerto Rican employment. Moreover, according to Treasury's third report, intangible intensive industries generally do relatively little to encourage the development of related industries in the possession, because their customers and suppliers are generally not in the possession.

Congress believed, in general, that no legitimate policy was served by permitting totally tax-free generation of income related to intangibles since that income is not ordinarily derived from increased Puerto Rican employment or economic activity. The Act is intended to lessen the abuse caused by taxpayers claiming tax-free income generated by intangibles developed outside of Puerto Rico. Congress also intended that the provisions be administered in a fashion so as to encourage increased Puerto Rican employment and investment in depreciable property at as low a cost to the Treasury as possible.

Congress was concerned about Puerto Rican job creation, and there was continuing concern that the Act might not be adequately targeted towards that goal. Congress intended that future Treasury annual reports on section 936 address this question in detail. Congress intended that the Treasury also consider in its annual reports whether a return attributable to intangible property might better encourage additional jobs and investment in Puerto Rico if it were measured by reference to costs of labor and capital located in Puerto Rico.

Virgin Islands provisions

Congress did not conclude that U.S. taxpayers were abusing the Virgin Islands tax system. Nonetheless, Congress believed that the prior V.I. system was susceptible of abuse. Moreover, Congress believed that reform of the possessions corporation system could induce some taxpayers to attempt to abuse the V.I. system. Therefore, Congress enacted revisions of the V.I. system that parallel the revisions of the possessions corporation system.

Explanation of Provisions

Qualified possession source investment income

The Act changes the active trade or business test that a U.S. corporation must meet to qualify for the possession tax credit.

It replaces the current requirement (that 50 percent or more of the corporation's gross income for the three-year period immediately preceding the close of the taxable year be derived from the active conduct of a trade or business in a possession) with a new requirement: that, for taxable years beginning in 1985, 65 percent of the corporation's gross income for the three-year period immediately preceding the close of the taxable year come from the active conduct of a trade or business in a possession. The provision is phased in so that the required percentage rises to 55 percent for taxable years beginning in 1983 and to 60 percent for taxable years beginning in 1984.

The bill does not alter the current definition of qualified possession source investment income. The bill also does not alter the current requirement that 80 percent or more of gross income for a three-year period be derived from sources within a possession. A corporation must meet both the 80-percent possession source income test and the 65-percent active trade or business test. Meeting the 65-percent active trade or business test does not guarantee satisfaction of the 80-percent possession source income test, because a company might derive all its income from a possession business while deriving more than 20 percent of that income from sources outside a possession.

Congress recognized that under the general rule relating to intangibles income added by the other major modification of section 936, contained in the Act and described below, the Internal Revenue Service or the courts may in later years treat certain active income as income of a taxpayer other than the section 936 corporation. Such treatment could, absent relief, cause retroactive disqualification under section 936, and a resulting loss of the section 936 credit. To provide a remedy, the Act allows section 936 corporations to make "distributions to meet qualification requirements" to their shareholders in later years. The Act allows section 936 corporations to treat these distributions as consisting wholly of disqualifying income. The U.S. recipients of such distributions must include them in income in the year received, without the dividends received deduction. Recipients of such distributions who are nonresident aliens or foreign corporations, estates or trusts are to be taxed as if the recipient were a U.S. person. This is accomplished by designating this income as "effectively connected" with the conduct of a trade or business through a permanent establishment of such person within the United States. In this way a section 936 corporation may avoid retroactive disqualification.

However, a distribution to meet qualification requirements is not available when the failure to meet the test was due to fraud or willfull neglect.

Allocation of income attributable to intangibles

General rule

Subject to an election by the 936 corporation to opt for different treatment, the Act provides that income attributable to intangible assets owned or leased by a section 936 corporation generally is not income of the section 936 corporation but is instead the income of the corporation's U.S. shareholders, with proration of income on the basis of shareholdings. The purpose of this provision is generally to subject to U.S. tax income attributable to intangibles that add value to the products produced by a section 936 corporation.

A different rule applies to the extent that shareholders of the section 936 corporation are foreign persons or are not subject to tax on such income. In such a case, the pro rata portion of the intangible property income that would have been allocated to such persons (if they had been U.S. persons subject to tax on such income) is instead treated (for the purpose of determining the tax liability of the section 936 corporation) as U.S. source income of the section 936 corporation. The section 936 possessions credit cannot offset this intangible property income. However, such intangible property income of the section 936 corporation does not enter into the calculation of the 80-percent possession source test or the 65-percent active trade or business test. In summary, the 936 corporation will be subject to U.S. income tax on intangible property income that is not allocated to shareholders (because they are foreign or tax-exempt), but such income will not operate to disqualify the corporation as a section 936 corporation.

For example, if a section 936 corporation has only $1,000 of gross income from an active business in Puerto Rico and from Puerto Rican sources, and $600 of that gross income is intangible property income, U.S. taxpayers will be subject to tax on the $600 intangible property income. If, in the same example, 80 percent of the shares of the 936 company are held by a U.S. corporation (which is not a 936 company), 10 percent by a foreign corporation, and 10 percent by a U.S. pension plan, the U.S. corporation is taxable on $480, while the section 936 company is taxable on $120. The U.S. shareholder is not entitled to a dividends received deduction for the $480, because this amount is not a dividend, but is rather intangible property income. The section 936 credit is not available to offset the tax on the $120 of intangible property income earned by the section 936 corporation. The $120 is also U.S. source income for purposes of the 936 company's foreign tax credit limitation. Because, for purposes of the 80 percent possession source test and the 65 percent active business test (taking into account only the year described), the 936 company's gross income for the year described does not include any intangible property income, in the example above the 936 company's gross income for these purposes is $400 and both tests are met. In this example, all $400 is both from an active Puerto Rican business and from Puerto Rican sources; therefore, the section 936 corporation has 100 percent possession source income and 100 percent active possession business income.

The bill defines intangible assets broadly to include patents, inventions, formulas, processes, designs, patterns, know-how, copyrights, literary, musical, or artistic compositions, trademarks, trade names, brand names, franchises, licenses, contracts, methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data, and other items similar to any of those listed, so long as the item has substantial value independent of the services of individual persons.

Intangibles the income from which is allocated to U.S. persons generally include those intangibles whose value is reflected in the price received by the section 936 corporation on any disposition of property. However, there is no allocation of income to U.S. persons in the case of income from intangibles which have been licensed to a corporation since prior to 1948 (the beginning of Puerto Rico's "Operation Bootstrap" tax incentive program) and were in use by that corporation on September 3, 1982.

Income attributable to intangibles includes the amount received in excess of a reasonable return on any sale the price of which reflects the value of intangible assets. A reasonable return for a section 936 corporation consists of the reasonable direct and indirect costs it incurs in manufacturing the product (other than costs incurred in connection with intangibles) plus a reasonable profit margin. Costs do not include the cost of materials which are subject to processing or which are components in a product manufactured by the section 936 corporation. Also, costs do not include interest expense.

Despite this rule for calculating a reasonable return for a section 936 corporation, certain taxpayers who have been permitted by the Internal Revenue Service to use the cost-plus method of pricing without reflecting a return from intangibles but including the cost of materials in the cost base will not be precluded from doing so under the Act. (Sec. 3.02(3), Rev. Proc. 63-10, 1963-1 C.B. 490.) Congress did not intend any change in current treatment with respect to those taxpayers appropriately applying the cost-plus method. Accordingly, the Internal Revenue Service may continue in appropriate cases to permit such taxpayers to report their income as they have been under existing procedures.

The Act generally treats a section 936 corporation as related to another person if such persons are related parties for purposes of sections 267(b) or 707(b)(1) or members of the same controlled group of corporations (as defined in section 1563(a)), except that the Act substitutes a greater than 10 percent test for the 50 percent or 80 percent tests of these sections and includes otherwise excluded foreign affiliates.

In the hands of a U.S. shareholder, income attributable to intangibles will be U.S. source income. As a practical matter, creditability of any income tax imposed by a possession on such U.S. source income will depend on the U.S. shareholder's overall foreign tax credit limitation, which limits the credit to the taxpayer's U.S. tax liability on foreign source income.

The Act's allocation to U.S. shareholders of intangible property income is effective even though such shareholders may not actually have received those amounts. Ordinarily, the actual receipt of such amounts, already included in income, will not trigger additional tax liability in later years. Congress anticipated that the Internal Revenue Service would establish correlative and similar adjustments (such as those provided in Revenue Procedure 65-17, as amplified and amended) to provide for the exclusion, when appropriate, of previously taxed amounts. However, if the Internal Revenue Service later increases the U.S. shareholder's income for the year in which the intangible property income was earned because the U.S. shareholder, due to fraud or with a principal purpose of avoiding tax, did not include his allocable share of intangible property income in his return for that year, the U.S. shareholder will not be able to exclude such amounts on receipt.

Optional methods

An election may be made, however, to opt out of the general rule described in this section and to treat income attributable to certain intangible property as income of the section 936 corporation eligible for the credit under one of two options—(1) a cost sharing rule and (2) a 50/50 profit split.

Cost sharing rule

Overview

A U.S. parent or other U.S. affiliate (collectively, "mainland affiliate") will be permitted to transfer certain manufacturing intangibles to its U.S. subsidiary or affiliate operating in a U.S. possession ("island affiliate"), provided the island affiliate (1) shares, through a cost sharing payment, in the annual product area research expenditures of the mainland affiliate and other affiliates controlled within the meaning of section 482 (collectively, "affiliates"), and (2) has a significant business presence in the possession. If these conditions are satisfied, the island affiliate will be deemed to own such manufacturing intangibles and will be entitled to the full return thereon with respect to the products produced or type of services rendered by the island affiliate. The applicable pricing methods provided in the section 482 regulations will be utilized for this purpose. An island affiliate which makes the election will not be classified as a contract manufacturer with respect to the manufacturing intangibles. All other intangibles, such as marketing intangibles (including trademarks, trade names, and brand names) cannot be transferred to the island affiliate under this election, with the result that, for purposes of this election, the island affiliate cannot claim a return on such intangibles.

Manufacturing intangibles

The manufacturing intangibles covered by this election and with respect to which the island affiliate may claim a return must be related to the products produced or services rendered by the island affiliate.

Manufacturing intangibles include patents, inventions, formulas, processes, designs, patterns, and know-how. Even when marketing intangibles are closely associated with a specific manufacturing intangible, the return on the marketing intangible cannot be claimed by the island affiliate.

Cost sharing payment

The cost sharing payment will be equal in amount to a fraction of the current year's worldwide direct and indirect product area research expenditures. The fraction will generally equal the ratio of third party sales of products produced or services rendered, in whole or in part, in the possession to third party sales of all products produced or services rendered by the island affiliate and its affiliates (U.S. and foreign) in the same product area. The product area will be defined by reference to the three-digit classification of the Standard Industrial Classification ("SIC") code, or such other classification system as may be specified by the Secretary. The Secretary may provide rules for the aggregation of two or more three-digit categories in appropriate circumstances. An election of the cost sharing method is available even if no cost sharing payment is required (e.g., because of the absence of product area research expenditures).

(1) Multiplicand: product area research expenditures

Product area research expenditures, which will be defined on a three-digit SIC Code basis (or other classification system specified by the Secretary), are broadly defined and include both direct and indirect expenses (including expenses described in section 174) and a proper allowance of amounts expended for the acquisition or use of manufacturing intangibles and for the performance of research and development by another person, including qualified research expenses within the meaning of section 44F(b). They also include the costs of developing and purchasing research and development-related computer software.

Product area research expenditures will be determined on the basis of the product area for each activity in which the island affiliate conducts operations. The multiplicand will be computed on an annual basis and will include product area research expenditures in that product area which are incurred by the island affiliate and all affiliates (U.S. and foreign). Product area research expenditures incurred solely by the island affiliate in a taxable year (excluding amounts paid directly or indirectly to or on behalf of related persons and excluding amounts paid under any cost sharing agreement with related persons) will be offset against the amount of the cost sharing payment required to be made by the island affiliate for that year.

(2) Limiting Fraction: third party sales

(i) Numerator: possession sales.—The numerator of the fraction will be computed with reference to the products produced, and services rendered, in whole or in part, in the possession that are in the same product area used in the multiplicand. Sales in the numerator consist of sales of products produced in whole or in part (and services rendered) and sold by the island affiliate to third parties, and sales of products produced, and services rendered, by the

island affiliate and sold by any U.S. or foreign affiliate to third parties. Thus, inter-affiliate sales are eliminated for this purpose.

(ii) Denominator: total sales.—The denominator of the fraction will also be computed with reference to the same product area used in the multiplicand. Sales in the denominator consist of all sales in the same product area to third parties by the island affiliate and all U.S. and foreign affiliates. For this purpose, inter-affiliate sales are eliminated.

Significant business presence

For an island affiliate to be eligible to elect cost sharing for a product or type of service, it must have and maintain a significant business presence in the possession with respect to that product or type of service. This test is intended to require real and significant business activity in the possessions.

The island affiliate satisfies this requirement with respect to a product or type of service if (1) at least 25 percent of the value added by the affiliated group to the product is added by the island affiliate in a possession or (2) at least 65 percent of the direct labor costs of the affiliated group for the product or service (or in connection with the purchase and sale of goods not produced by the affiliated group) are incurred by the island affiliate and are compensation for services rendered in the possession. In general, the figures to be used for these calculations will be those used by the island affiliate and its affiliates in their required inventory calculations. The Secretary may prescribe regulations providing significant business presence tests for other appropriate cases (including a value added test for services), which are consistent with the statutory tests.

The significant business presence test is not required to be satisfied for taxable years beginning before January 1, 1986 for any product produced or type of service rendered in a possession by the island affiliate on the date of enactment. The Secretary may prescribe regulations to provide a transitional (up to 3-year) significant business presence test for future start-up operations of new electing corporations and future possession products and possession services of an existing island affiliate. Regulations will provide definitions of a product or type of service and rules for dealing with components in the context of the foregoing requirements. If the significant business presence test is not satisfied for a product or type of service within the product area covered by the election, the cost sharing payment will not be reduced, and the general rule of the Act (rather than this optional method) will apply to that product or type of service.

It was intended that the regulations will define the term "product" narrowly. In this manner the signficant business threshold test will be more readily satisfied than if a broader definition applied, with the consequence that the income attributable to a product that satisfied the test will be computed with respect to that narrowly defined product.

Similarly, it was intended that components purchased by an island affiliate from an affiliate will be treated as materials (and the costs thereof as a cost of materials) where there is an independent resale price for such components or other factors are present such that the proper arm's length price of the components can be readily determined and such treatment is consistent with the intent of the significant business presence tests.

The Secretary will prescribe regulations providing for appropriate treatment in cases where the island affiliate purchases a component produced by an affiliate or produces a component which it sells to an affiliate for incorporation into a product sold to third parties.

Effect of cost sharing

For U.S. tax purposes, the cost sharing payment will not result in additional gross income to the mainland affiliate or affiliates, but will instead reduce the mainland affiliates' deductions for product area research expenditures and, to the extent necessary, other tax deductions. The credit for increasing research activities under section 44F will not be reduced by reason of the cost sharing.

Effect of electing to make cost sharing payments

If an election is made to use the cost sharing option, manufacturing intangibles covered by the election which are connected with the goods produced, or services rendered, in whole or in part, in the possession will, for purposes of the pricing rules discussed below, be deemed to be owned by the island affiliate, and the island affiliate will be entitled to the full return thereon. It is not necessary that the intangibles be transferred to the island affiliate.

Manufacturing intangibles developed solely by the island affiliate in a possession and owned by it, or acquired by the island affiliate from an unrelated party, will also be treated as owned by it for purposes of the pricing rules. For the purpose of determining when the island affiliate will be considered to have developed an intangible, rules (the "developer rules") similar to certain of the rules of the section 482 regulations will be provided, but an intangible developed under a cost-sharing agreement shall not qualify as developed solely by the island affiliate.

Nonmanufacturing intangibles

If the cost sharing rule is elected, all other intangibles (including those purported to have been transferred to the island affiliate) will not be treated as owned by the island affiliate for purposes of the intercompany pricing rules; and the island affiliate will not be entitled to any return thereon unless such intangibles are developed solely (within the meaning of the developer rules) by the island affiliate in a possession and owned by it. A further exception will apply in the case of sales made directly by the island affiliate to unrelated parties for ultimate use or consumption in the possession, in which case the island affiliate will be entitled to the return on marketing intangibles developed by, or transferred by an affiliate to, the island affiliate.

Manufacturing intangibles and nonmanufacturing intangibles are defined according to lists of types of assets. Where an intangible is of a type which fits into two categories, e.g., a system, program, procedure or technical data (all defined as nonmanufacturing intangibles) which is also an invention, formula, process, design, pattern or know-how, it should be classified as a manufacturing or a nonmanufacturing intangible (or partly each) according to the use of the asset. For example a program (e.g., software) used in manufacturing which constitutes a formula, process or know-how (all manufacturing intangibles) and also is a program (a nonmanufacturing intangible) would be treated as a manufacturing intangible; but a program for a marketing campaign, even if also classified as know-how, would be treated as a program and hence as a nonmanufacturing intangible. So too, copyrights may be treated either as manufacturing intangibles or nonmanufacturing intangibles (or as partly each) depending upon the function or the use of the copyright.

Pricing

If the cost sharing payment is made, the island affiliate will be treated as the owner of, and entitled to the full return on, the manufacturing intangibles covered by this election and connected with the product produced, or type of service rendered, in whole or in part, by the island affiliate in the possession. The island affiliate will compute its intercompany price under any of the applicable pricing rules set forth in the section 482 regulations. Use of the resale price method will not be denied merely because the reseller (e.g., the mainland affiliate) added more than an insubstantial amount to the value of the property by the use of intangibles. In such a case, the value of the nonmanufacturing (e.g., marketing) intangibles and any other functions that add value (such as distribution) will be reflected in the resale margin. The use of the resale price method could be denied for other reasons, such as where the return on manufacturing intangibles is minor and no comparables can be found for determining an appropriate mark-up percentage under the resale price method. Thus, a cost plus method may be applied in appropriate cases, after applying the priority-of-application rules of the section 482 regulations, as long as an additional profit amount, representing the return on manufacturing intangibles covered by this election, is permitted the island affiliate. The Internal Revenue Service will not be precluded from applying section 482 with respect to other aspects of the intercompany relationship. The regulations under section 482 and Internal Revenue Service revenue procedures (Revenue Procedure 63-10, as amplified by Revenue Procedure 68-22) will continue to apply except to the extent modified by the election.

Timing of cost sharing payment

If the cost sharing election is made, payment of the required amount must be made by the island affiliate no later than the due date of its tax return for the year (including extensions). To the extent payment is not timely made (e.g., if a greater payment is determined on audit to have been required), the required payment is increased by an amount computed by reference to the interest rate applicable to income tax deficiencies. If the failure to make timely payment is due in whole or part to fraud or willful neglect, the island affiliate's election of the cost sharing method is deemed revoked as of the year to which the payment relates.

If a foreign country or possession imposes a tax on the cost sharing payment (or the late payment amount), no foreign tax credit or deduction will be allowed for that tax.

50/50 split of combined taxable income

Overview

This election will provide for a split between the island affiliate and its U.S. affiliates of the combined taxable income of the island affiliate and its U.S. affiliates with respect to products produced, in whole or in part, in the possession. Fifty percent of such profit will be allocated to the island affiliate; 50% will be allocated to its U.S. affiliates.

Significant business presence

For an island affiliate to be eligible to elect the profit split, it must satisfy one of the significant business presence tests required for the cost sharing election for the product or type of service covered by the election. In addition, for products produced in whole or part by the island affiliate in the possession, the profit split method is available only if the island affiliate manufactures or produces the product in the possession within the meaning of the controlled foreign corporation provisions of the Code (section 954). If the significant business presence test (including the controlled foreign corporation manufacturing or production rule) is not satisfied for a product or type of service within the product area covered by the election, no intangibles income attributable to that product or type of service will be eligible for the credit.

Combined taxable income

The determination of combined taxable income will be on a product by product basis.

The combined taxable income of the island affiliate and its mainland affiliates from the sale of the product produced in whole or in part in the possession is the excess of the gross receipts from the sale of such product to third parties or foreign affiliates over the total costs relating to such product incurred by the island affiliate and its mainland affiliates. Costs which are treated as relating to a product produced in whole or in part in the possession are all direct and indirect expenses, losses, and other deductions (including marketing expenses) with respect to sales of such product; i.e., the expenses will be "fully-loaded." In this regard, the amount of product area research expenditures properly allocable or apportionable to income from sales of such product may not be less than the amount determined under the cost sharing formula described above. However, if the island affiliate would not be required to share costs under the cost sharing election (e.g., because of the absence of product area research expenditures), the profit split option may still be elected.

Effect of electing 50/50 split

If an election is made, the island affiliate will be entitled to 50 percent of the combined taxable income from the sale of products produced or services rendered in a possession by the island affiliate and sold to third parties or foreign affiliates by the island affiliate or a mainland affiliate. The remainder of the combined taxable income for a product will be allocated to the mainland affiliates. This latter amount may exceed the island affiliate's share of the income from the product if the amount of proportionate product area research expenditures, determined under cost sharing, is in excess of the amount allocable to the combined taxable income absent application of the cost sharing formula. For example, if combined taxable income is $100 without taking into account research and development expenses allocable or apportionable thereto, the amount of such expenses is $10, and the amount computed under cost-sharing (without offsets for island affiliate expenses) is $12, the island affiliate's share of combined taxable income is $44 (one-half of $88), and the mainland affiliate's share of combined taxable income is $46 ($100 less $10 of allocable and apportionable expenses and less the island affiliate's $44 share). Thus, the use of this formula is not intended to allow a deduction to any mainland affiliate which would not otherwise be allowable.

Election

An election must be made on or before the due date (including extensions) of the tax return of the electing corporation for its first taxable year beginning after December 31, 1982. An election may be revoked only with the consent of the Secretary. Once revoked, a new election may not be made without the consent of the Secretary. All section 936 affiliates, controlled within the meaning of section 482, producing products or rendering types of services in the same product area will be required to elect the same option for that product area, except that one of the two options may be used for bona fide export sales where the other option is applicable to other sales.

Transfers of intangibles

Under present law, certain transfers by a U.S. person to a foreign corporation that would otherwise obtain tax-free treatment are taxable unless the Internal Revenue Service issues a ruling that they do not have as one of their principal purposes the avoidance of Federal income tax (sec. 367). The Internal Revenue Service has published guidelines stating when the Service will and will not issue rulings that transactions do not have a tax avoidance purpose. Under the guidelines certain transfers of property for the active conduct of a trade or business abroad are ordinarily not taxable (Rev. Proc. 68-23, 1968-1 C.B. 821 and other releases). However, transfers to foreign corporations of patents, trademarks, and similar intangibles for use in connection with a U.S. trade or business or with manufacturing for sale or consumption in the United States generally are subject to taxation under these guidelines.

By negative implication, transfers of intangibles for use purely in connection with a foreign trade or business or manufacturing for sale or consumption outside the United States generally may not be taxable. Congress recognized that the Internal Revenue Service has authority, under existing law, to find a tax avoidance purpose when an intangible asset is transferred to a foreign corporation. Whether or not the guideline is appropriate as a general rule, Congress was aware that, as a result of this legislation, some taxpayers have stated that they would remove investment from Puerto Rico and transfer possession-related intangibles to foreign jurisdictions. Congress believed that such transfers would ordinarily have as one of their principal purposes the avoidance of Federal income tax.

The Act amends the provision of the Code dealing with tax-free transfers to foreign corporations to treat a transfer of a possession-related intangible to a foreign corporation as a transfer pursuant to a plan having as one of its principal purposes the avoidance of Federal income taxes. The provision applies to a transfer by a possessions corporation or an affiliated U.S. corporation after August 14, 1982, where the intangible property was being used (or held for use) by an affiliated possessions corporation. The Secretary may, subject to such terms and conditions as he may impose, allow nonrecognition treatment with respect to such transfers, if the Secretary is satisfied that the transfer will not result in the reduction of current or future Federal income taxes.

Congress did not intend for taxpayers to be able to circumvent this rule, relating to transfers of intangible property to related parties, by transferring intangible property similar to (or included in) property whose transfer would be subject to tax under this rule. Such a transfer, made with the intention of circumventing the rule, would be in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. Accordingly, the Secretary is not to allow nonrecognition treatment to a transfer of similar (or included) intangible property, because in that case he would not be satisfied that that transfer would not result in the reduction of current or future Federal income taxes.

The Act also subjects to tax post-July 1, 1982, sales of intangible property to related persons. The income from such sales is U.S. source income, and the cost-sharing and 50/50 profit-split elections do not apply with respect to that income. The income from such sales will not affect the corporation's qualification (under the possessions source and active income tests) as a possessions corporation.

Revocation of section 936 election

Under present law, an election of the application of section 936 may be revoked before ten years only with the consent of the Secretary. Congress anticipated that because of the basic change in the taxation of possessions corporations the Secretary will consent to the revocation of an election by a section 936 corporation provided the election is in effect for the corporation's last taxable year beginning before January 1, 1983. Congress intended that this liberal consent policy apply only if the consent is requested on or before December 31, 1983, and that the Secretary be permitted to impose conditions on such revocation, such as requiring that the taxpayer obtain the Secretary's consent before reelecting the application of section 936.

Virgin Islands provisions

The Act creates rules for the Virgin Islands similar to those for the other possessions. The Act prevents U.S. companies that are "inhabitants" of the Virgin Islands from earning passive investment income free of U.S. and V.I. taxes by providing that the Virgin Islands may not grant tax rebates to any U.S. corporation unless that corporation meets a 65 percent active trade or business test identical to that provided for section 936 corporations. As is the case with section 936 corporations, the Act provides a phase-in of the 65 percent test and a method to qualify under this test retroactively if allocation of income from intangibles to related U.S. parties was inadequate.

The Act generally treats the intangibles income of U.S. corporations that are inhabitants of the Virgin Islands like intangibles income of section 936 corporations. Subject to an election to opt for different treatment, such U.S. corporate V.I. inhabitants must allocate income attributable to certain intangibles to U.S. shareholders of the V.I. inhabitant. The rules for such allocation are the same as the rules described above for section 936 corporations. To the extent that the shareholders of the V.I. inhabitant are foreign persons, V.I. inhabitants or other persons not subject to U.S. taxation, the bill prevents the Virgin Islands from exempting the V.I. inhabitant from tax on intangible property income.

The Act provides for U.S. corporate inhabitants of the Virgin Islands the same elective rules for treatment of income from intangibles as it provides for section 936 corporations. In addition, the Act subjects post-August 14, 1982, transfers of intangible property to foreign corporations by U.S. or V.I. corporate inhabitants of the Virgin Islands to the treatment, described above, of such transfers by section 936 corporations. Similarly, the Act treats post-July 1, 1982, sales of intangible property to related persons by U.S. corporate inhabitants of the Virgin Islands like such sales by section 936 corporations.

Effective Date

The Act applies generally to taxable years beginning on or after January 1, 1983. The provision relating to sales of intangibles applies to sales made after July 1, 1982. The provision relating to transfers of certain intangible property applies to transfers made after August 14, 1982.

Congress did not intend that possessions corporations or U.S. corporations that are inhabitants of the Virgin Islands have the automatic right to delay the impact of the rules of the Act for part of a year by changing their annual accounting periods. If a taxpayer changes its annual accounting period, the new accounting period becomes the taxpayer's taxable year only if the Secretary approves the change (sec. 442). Although the Secretary has adopted regulations (Reg. sec. 1.442-1(c)) allowing corporations to change their annual accounting periods and to adopt new taxable years without the prior approval of the Secretary in certain circumstances, Congress did not intend those regulations to apply in the case of a possessions corporation or a U.S. corporation that is a V.I. inhabitant when one effect of a change of annual accounting period and the adoption of a new taxable year would be to delay the impact of the Act's new rules. Thus, a possessions corporation or U.S. corporation that is a V.I. inhabitant that seeks to change its annual accounting period and adopt a new taxable year must obtain the prior approval of the Secretary when one effect of those changes would be to delay the impact of the Act's new rules.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $201 million in 1983, $428 million in 1984, $473 million in 1985, $516 million in 1986, and $559 million in 1987.

8. Tax-Exempt Obligations*

a. Restrictions on tax-exempt bonds for private activities (secs. 214, 215, 216, and 219 of the Act and secs. 103 and 168 of the Code)

Prior law

General rule

Under both prior and present law, interest on State and local government obligations generally is exempt from Federal income tax; however, industrial development bonds (IDBs) are taxable except when issued for certain specified purposes.

Under both prior and present law, interest on IDBs is tax-exempt if the bonds were issued to finance the following activities: (1) projects for low-income residential rental property; (2) sports facilities; (3) convention or trade show facilities; (4) airports, docks, wharves, mass commuting facilities, and parking facilities; (5) sewage and solid waste disposal facilities, and facilities for the local furnishing of electricity or gas; (6) air or water pollution control facilities; (7) certain facilities for the furnishing of water; (8) qualified hydroelectric generating facilities; and (9) qualified mass commuting vehicles. In addition, the interest on certain IDBs issued for the purpose of acquiring or developing land as a site for an industrial park is exempt from taxation.

Both prior and present law allow unlimited tax-exempt financing for student loans and organizations that qualify for tax-exemption under section 501(c)(3), such as private, nonprofit hospitals and private, nonprofit educational institutions for use for exempt purposes.

Small-issue exception for IDBs

Both prior and present law also permit tax exemption for certain "small issue" IDBs if the proceeds are used for the acquisition, construction, or improvement of land or depreciable property. Under prior law, there were no restrictions on the business activities in which land and depreciable property financed with "small issue" IDBs could be used.

This exception applies to issues of $1 million or less without regard to the total capital expenditures for the facility (i.e., the $1 million "clean limit" exception).[1] At the election of the issuer, the limitation is increased to $10 million where certain capital expenditures (discussed below) are taken into account. In the case of facilities with respect to which an Urban Development Action Grant ("UDAG grant") under the Housing and Community Development Act of 1974 is made, capital expenditures of up to $20 million are allowed.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, secs. 221–224; S. Rep. No. 97–494, vol. 1 (July 12, 1982), pp. 165–185; Senate floor amendments, 128 Cong. Rec. S8984–85 (July 22, 1982); and H. Rep. No. 97–760 (August 17, 1982), pp. 514–527 (Joint Explanatory Statement of the Committee of Conference).

[1] Before promulgation of Rev. Rul. 81-216, 1981-36 I.R.B. 6 (September 8, 1981), discussed below, small issue IDBs could be marketed as a separate IDB issue in combination with exempt activity IDBs for a single business project.

Both the $1 million and $10 million limitations are determined by aggregating the face amount of all outstanding small issues for all facilities used by the same or related principal users which are located within the same county or same incorporated municipality. Where the $10 million election is made, the $10 million limitation is reduced to the extent that the principal users of the facilities incur certain capital expenditures in the same county or same incorporated municipality during the six-year period beginning 3 years before, and ending 3 years after, the issuance of the bonds.

Other rules

Under prior law, facilities financed with tax-exempt IDBs could be depreciated under the Accelerated Cost Recovery System (ACRS) or other available accelerated methods of cost recovery provided under the Code. Under both prior and present law, IDB-financed property also qualifies for the investment tax credit.

Prior law was unclear on the length of time that bonds could be outstanding in relation to the economic life of the property financed with tax-exempt financing.

Prior law imposed no reporting requirements on issuers of tax-exempt bonds for private activities. Additionally, there were no Federal procedural requirements governing the manner in which such bonds were issued.

Reasons for Change

Overview

Congress was concerned with the volume of tax-exempt bonds used for private activities. There has been a tremendous increase in recent years in the volume of such bonds. In 1976, the volume of private activity bonds was about $8.5 billion, or about 25 percent of the long-term tax-exempt bond market. The volume of private activity bonds rose to more than $25 billion in 1981, representing 48 percent of the tax-exempt bond market. The Treasury Department estimated that over $35 billion of private activity bonds would be issued in 1982, consuming over 55 percent of the entire long-term tax-exempt bond market.

The proliferation of private activity bonds has contributed to a significant narrowing of the difference in interest rates between tax-exempt and taxable bonds. While tax-exempt rates historically have been about 65 to 75 percent of taxable rates, tax-exempt bonds generally were yielding about 80 to 85 percent of the taxable rates when the Act was being considered. This erosion of the relative advantage of tax-exempt financing has made it more costly for state and local governments to finance essential public projects such as schools, roads, and prisons. It also has made tax-exempt financing even less cost effective as a subsidy since more of the benefit flows to bond investors as tax-exempt rates grow closer to taxable rates. The increasing volume of private activity bonds has also caused mounting Federal revenue losses. The Treasury Department estimated that the total Federal revenue loss from private activity tax-exempt bonds outstanding in fiscal year 1981 was $3.2 billion and would be $4.2 billion for private activity obligations outstanding in fiscal year 1982.

The availability of tax-exempt financing for exempt activities and other private activities causes distortions in the allocation of scarce capital resources. The ability to obtain a lower cost of borrowing for certain activities through the use of tax-exempt financing creates a bias in favor of investment in those activities. In effect, those favored activities are subsidized at the expense of other activities. Thus, the effect of the subsidy is that the allocation of capital investments is based upon government decisions rather than their relative economic productivity.

While the growth of private activity bonds in recent years has been large, information concerning the specific uses was incomplete. Accordingly, in order to enable the Congress and others to monitor the use of tax-exempt bonds for private activities and to help in enforcing other restrictions on (IDBs), the Act requires issuers to make quarterly reports to the Internal Revenue Service on private activity tax-exempt obligations issued by them.

Industrial development bonds

Congress believed that new restrictions were needed on IDBs to help eliminate inappropriate uses and to help restore the benefit of tax-exempt financing for traditional governmental purposes. However, Congress believed that, in general, State and local governments are best suited to determine the appropriate uses of IDBs. Congress believed that providing tax exemption for the interest on certain IDBs may serve legitimate purposes in some instances provided that the elected representatives of the State or local governmental unit determine after public input that there will be substantial public benefit from issuance of the obligations and provided that the affected public has had an opportunity to comment on the use of tax-exempt financing for particular facilities. In order to achieve this goal, the Act requires notice and a public hearing and approval by an elected representative of the issuer before issuance of any IDBs.

Congress also was concerned with the combined subsidies provided for investment from the tax rules for accelerated cost recovery, investment tax credit, and tax-exempt financing. In most cases, Congress believed that the combined subsidies were too generous and that new restrictions in cost recovery deductions taken by private taxpayers for property financed by IDBs were necessary. Therefore, the Act requires taxpayers to choose between (1) ACRS and conventional financing and (2) tax-exempt financing and a slower rate of cost recovery than that provided by ACRS. Congress did not believe such a requirement would reduce the use of IDBs in appropriate circumstances, but would simply eliminate an unnecessary portion of the total subsidy available to the user of the bond proceeds.

However, Congress believed that extraordinary levels of subsidy are necessary in the case of certain types of property. In those cases, both tax-exempt financing and the full ACRS deductions are made available. Congress believed that additional levels of subsidy are appropriate for low income rental housing, public sewage or solid waste disposal facilities, air or water pollution control facilities installed in existing plants, and projects financed in part with a UDAG grant.

Small issue industrial development bonds

Congress also was particularly concerned with the extraordinarily rapid growth in the volume of small issue IDBs. In 1976, according to the Treasury Department, the volume of new, small issue IDBs was $1.4 billion. In 1981, that volume had grown to $10.5 billion, an annual rate of growth of 50 percent. By contrast, public activity bonds grew at an annual rate of approximately 1 percent during the same period. Continued growth in the use of small-issue tax-exempt bonds for private purposes was expected unless actions were taken to limit their use. Under prior law, for instance, the annual volume of new small issues by 1987 was estimated to be $31.3 billion.

In addition to its concern with the increasing volume of small issue bonds, and the impact of that volume on the market for public activity tax-exempt securities, Congress was concerned with (1) the use of small issue IDBs by large companies that are able to raise funds readily in capital markets without a Federal subsidy, (2) the use of small issue IDBs to finance a variety of types of facilities, from private recreational facilities to fast food restaurants, that generally may be less deserving of a Federal subsidy than other types of facilities, and (3) the lack of any substantial targeting of the use of small issue IDBs to economically distressed or otherwise needy areas.

While Congress considered several alternatives to limit the volume and reform the use of small issue IDBs, the absence of comprehensive and reliable information regarding the uses of small issue IDBs hampered Congress' capacity to determine the appropriate role, if any, to be played by small issue IDBs for the future. Instead, Congress determined that the use of small issue IDBs should be terminated after 1986. In certain cases, however, Congress determined that the small issue exception should be eliminated before 1986. Therefore, the Act provides that the exemption is not available for bonds issued after 1982 if 25 percent or more of the proceeds are used to finance facilities for automobile sales or service, retail food and beverage service (other than grocery stores) or provision of recreation or entertainment. The Act further eliminates the exception after 1982 if any portion of the proceeds of an issue are used to finance certain other specified recreation facilities (e.g., golf courses, hot tub facilities, etc.).

Congress did not intend by these actions to preclude further consideration by it of the appropriate use of small issue IDBs. Indeed, Congress intended that it undertake in a timely manner and with substantially more information than is presently available, a comprehensive review as to whether the continued use of small issue IDBs is economically warranted, and, if so, how that use should be further restricted.

Explanation of Provisions

Overview

The Act requires issuers of private activity bonds to make quarterly information reports to the Internal Revenue Service with respect to each issue; requires approval of IDB issues by an elected official or legislative body following a public hearing before issuance (or, in lieu of such approval and hearing, a voter referendum conducted); reduces, with certain exceptions, cost recovery deductions for IDB-financed property; eliminates use of the small issue exception for IDBs issued as part of a single issue with bonds exempt under any other provision; repeals the small issue exception for obligations issued after 1986; eliminates the current use of small issue bonds to finance certain facilities; and limits the average length of time to maturity of IDBs.

Information reporting requirements

Under the Act, issuers of all bonds used to finance private activities are required to report certain information to the IRS about such bonds issued by them during the preceding calendar quarter. This report must be made no later than the 15th day of the second month after the close of the calendar quarter in which the bonds are issued. The reporting requirement applies to all IDBs, student loan bonds,[1] and tax-exempt bonds a major portion of the proceeds of which are used by charitable, etc., organizations (described in sec. 501(c)(3)). The required reporting also applies to refunding issues even if the original bonds were issued before 1983, if the refunding occurs after 1982.

The quarterly report must contain substantially all of the following information with respect to each issue:

(1) the date of the issue, the stated interest rate, the term, the face amount of each bond that is a part of the issue, and the amount of lendable proceeds from the issue;

(2) the name of the elected official or legislative body that approved the issue or a description of the voter referendum, if any;

(3) the name, address, and tax identification number of each initial principal user of any facilities financed with the proceeds of the issue, its common parent, and certain persons who provide property, a trademark, trade name, or franchise to the principal user; and

(4) a description of the property, facility, or project for which the proceeds are to be used.

Congress intended that the property financed by the bonds be identified in the quarterly report on an asset-by-asset basis (by cost recovery class, if any) and by a general description of the facility or project. Unless there is substantial compliance with this requirement, interest on the obligations is not tax-exempt. The IRS is authorized to extend the time for filing these reports for reasonable cause. Congress anticipated that the IRS will make compilations and summaries of the reported information available to Congress and that this information will become a matter of public record at that time.

---

[1] Student loan bonds include State and local government bonds used to finance, directly or indirectly, any educational or related expenses regardless of whether the loans are guaranteed by the Federal or State governments.

Public hearing and approval or voter referendum requirements

General rule

The Act establishes new approval requirements for issuers of IDBs.[2] Failure to comply with these requirements will result in loss of tax exemption for the interest on the bonds. The new requirements are twofold: (1) reasonable notice must be given and a public hearing held and (2) issuance of the bonds must be approved after the hearing by an elected public official or elected legislative body. Each requirement is intended to operate independently of existing or future State law requirements although, in many instances, existing or future procedures provided for by State law may satisfy the new Federal requirements. Alternatively, a voter referendum, held at such time and in such manner as referenda on other issues affecting government spending under applicable State and local law, may be used in place of the hearing and elected representative approval requirements with respect to any governmental unit.

Public hearings and approval by an elected official or legislative body are required by both the issuing jurisdiction and the jurisdiction where the facilities are located. The hearing must be held before the approval of the bonds.

Where the facilities are located entirely within the geographic jurisdiction of the issuing governmental unit, only one public hearing and approval are required even though the facilities may be located in several different subdivisions of the issuing governmental unit.

Where facilities are not located within the geographic jurisdiction of the issuing governmental unit, at least one governmental unit having geographic jurisdiction over each facility must hold a hearing and approve the bond issue. This may be either a single governmental unit or a series of smaller governmental units that may be subdivisions of the single governmental unit. For example, where a governor of a State is to approve the issuance of bonds for facilities located in that State (even though located in several counties), only the State is required to have a public hearing on that bond issue. Where, however, a facility is located in several counties and each county's elected executive officer is to approve the issuance of the bonds for facilities located in that county, each county is required to have a public hearing on that bond issue.

Where a facility is located in more than one State, then the hearing and approval requirements are applied as if there were separate facilities in each State. Thus, for example, in the case of electric transmission lines that cross State lines, the transmission lines located in each State are treated as separate facilities and each State or its counties where the separate facilities are located is required to meet the public hearing and approval requirements.

---

[2] Since this restriction only applies to IDBs, it generally does not apply to student loan bonds or bonds for tax-exempt organizations (described in section 501(c)(3)).

Notice and hearing

If the voter referendum alternative is not used, the Act requires that a public hearing be held by the issuer of all tax-exempt IDBs and by each other governmental unit in which any IDB-financed facility is to be located.

The hearing must be preceded by published notice reasonably designed to apprise residents of the affected governmental units of the proposed issuance of the bonds. Congress anticipated that such notice generally would be published no less than 14 days before the scheduled date of the hearing. The hearing should be conducted in a manner that provides a reasonable opportunity for persons with differing views on both issuance of the bonds and the location and nature of the proposed facility to be heard. It is not necessary that the elected official who will approve the bonds be present at the hearing or that a report on the hearing be submitted to that official, although it is contemplated that an issuer may wish to take these steps to better inform the elected representative required to approve the bonds. In addition, Congress did not intend that this requirement automatically invoke any State administrative procedural requirements as to hearings in general.

Congress intended that the hearing may be held directly by the governmental unit or its agencies or by a person who issues bonds on behalf of that governmental unit. Generally, the hearing should be held at times and in places that will be convenient for persons affected by the facilities financed by the IDBs. However, where an IDB will finance more than one facility at different locations, it is not necessary that separate hearings be held for each facility. For example, where a State agency proposes to issue an IDB to finance projects throughout the State, only one hearing need be held somewhere within the State for all the facilities financed with the IDB provided adequate public notice of the hearing is given in all areas where facilities are to be located.

Approval by elected representative

Following the public hearing and prior to issuance of the bonds, the applicable elected representative of each governmental unit holding the required hearing, must approve issuance of the bonds.[3] The Act provides that the applicable elected representative is generally to be the chief elected executive of the governmental unit, the chief elected State legal officer of the executive branch, or an elected legislative body (e.g., city council, etc.).[4] If multiple legislative bodies have authority over issuance of bonds in a jurisdiction, the body with more specific authority must approve their issuance. For example, if an elected board of directors of an industrial development authority of a city and an elected city council are both authorized to approve issuance of IDBs, IDBs related to industrial development would be approved by the board of directors of the industrial development authority rather than the city council. However, if the board of directors of the industrial development bond authority is not elected, then the elected city council must approve the bonds regardless of whether the board is authorized to issue IDBs. Special rules are included permitting designation by the applicable elected representative otherwise required to approve bond issues of another elected representative to approve bond issues. In no case, however, can the approval be by an individual or body not elected by the residents of the affected governmental unit. If there are no elected officials or elected legislative bodies of a governmental unit, the approval requirement must be met by an appropriate elected official of the next higher level of government that has an elected official or an elected legislative body and from which the lower level of government derives its authority.

---

[3] The approval of an appropriate elected representative required by the Act may occur before or after the governmental unit commits itself to issue the bonds. Consequently, the approval requirement does not affect the present law rule that an inducement resolution be approved prior to commencement of construction in certain cases; however, the jurisdiction cannot bind itself to exercise the approval required by the Act prior to the hearing.

[4] In the case of a bicameral legislative body, the required approval must be by both chambers of the body.

Exception for certain subsequent and refunding issues

Under the Act, a public hearing and approval by an authorized elected representative is not required for certain issues solely to refund a prior issue, provided the original issue was approved by the appropriate elected official following such a hearing. This exception does not apply, however, in the case of refunding bonds that will mature after the date on which the bonds to be refunded would have matured.

The public hearing and approval requirements also do not apply to certain subsequent issues by the same governmental unit for a facility when the subsequent issues occur within 3 years of the initial issue date of an approved issue. This exception permits issuers to approve up to a 3-year plan of financing for a facility while satisfying the public hearing and approval requirements once, either prior to or at the time of the initial issue. For example, an issuer could approve financing for a facility with a specified amount of IDBs to be issued as different phases of construction occur. In such a case, provided the funds are all used for the same facility and all obligations are issued within a 3-year period pursuant to the plan of financing, only one public hearing and approval by an elected representative is required. This exception will not apply, however, to IDBs issued to finance different facilities or not issued pursuant to a single plan of financing even when the facilities are owned or used by the same party (or a related party).

In addition, Congress intended that the special rule which permits approval of a plan of financing for up to 3 years also applies to refunding obligations issued within that 3-year period. For example, the rule covering plans of financing would cover situations where IDBs are issued and then refunded one or more times within the 3-year period. The 3-year period commences on the date that obligations are first issued pursuant to the approval of the plan.

Restriction of cost recovery deductions for certain property financed with tax-exempt bonds

General rule

The Act provides that property that is placed in service[5] after December 31, 1982, generally is not eligible for full cost recovery deductions under ACRS or other accelerated cost recovery provisions of the Code, to the extent that the facilities are financed by any tax-exempt bonds.[6] In lieu of full deductions under ACRS, the cost of property financed with IDBs must be recovered using the straight-line method (with a half-year convention for personal property and a monthly convention for real property) over the applicable ACRS recovery period. This limitation applies to both the first owner of the property and to any subsequent owners who acquire the property while the IDBs (including any refunding issues) are outstanding.

Exceptions for certain facilities

The Act provides several exceptions permitting the cost of certain types of facilities financed in whole or in part with IDBs to continue to be recovered under ACRS: low income rental housing, public sewage or solid waste disposal facilities, certain new air or water pollution control facilities, and certain facilities for which UDAG grants are made.

Low-income rental housing, which will continue to qualify for both tax-exempt financing and ACRS, is any residential rental property that is described in section 103(b)(4)(A). In addition, certain multi-family rental projects also are exempt from the cost recovery provisions of the Act if the project was exempt from the restrictions on the use of IDBs for multi-family housing under the Mortgage Subsidy Bond Tax Act of 1980.

Public sewage or solid waste disposal facilities, which will continue to qualify for both tax-exempt financing and ACRS, are any such facilities which are financed with obligations the interest on which is exempt pursuant to section 103(b)(4)(E) where substantially all of the sewage or solid waste (other than recycled waste) processed by the facility is collected from the general public.

Facilities will qualify for this exception regardless of whether the solid waste or sewage is collected from an area within part or all of a government unit or an area larger than one governmental unit; regardless or whether the facilities are operated by a governmental unit or a private company; and regardless of whether the facilities accept for processing all types of waste (as long as the waste accepted is collected from the general public). Solid waste need not include waste separated by source or recyclable materials.

For this purpose, the general public includes commercial and other businesses but only if the solid waste collected from businesses is collected from them in their capacities as members of the general public and not as members of a limited group (such as groups that have special types of waste not processable by normal waste facilities serving the general public).

---

[5] For this purpose, property is placed in service when it is eligible for capital cost recovery deductions.

[6] If the tax-exempt IDBs are first issued after the property is placed in service, the taxpayer is required to recompute any cost recovery deductions claimed for that property in prior years.

The air or water pollution control facilities, which will continue to qualify for ACRS deductions and tax-exempt financing, are air or water pollution control facilities which are financed with obligations the interest on which is exempt under section 103(b)(3)(F) and which are used in connection with a plant or other property in operation before July 1, 1982. In addition, air or water pollution control facilities used in connection with conversion of oil- or gas-fired facilities to coal will be permitted cost recovery deductions under ACRS, but only if the oil- or gas-fired furnace which is converted to coal was in use at the facility before July 1, 1982. For example, installation of a new coal furnace after July 1, 1982, will not disqualify related pollution control equipment from ACRS deductions if the replaced oil- or gas-fired furnace was in operation at the facility as of July 1, 1982.

Finally, facilities financed with tax-exempt bonds, which are eligible for the special rule relating to UDAG grants, will continue to be permitted ACRS. This exception will not apply unless the amount of the UDAG grant equals or exceeds 5 percent of the total capital expenditures on the facility. In the case of property partially financed by a UDAG grant that benefits multiple facilities, only an allocable share of the grant is used in determining whether this capital expenditure test is satisfied for any individual facility.

Relationship of bond maturity to life of assets

The Act provides a rule that limits the average length of the maturity of all IDBs. Under the rule, the weighted average maturity[7] of all obligations of an issue cannot exceed the weighted average estimated economic life[8] of the assets financed with the proceeds of the issue[9] by more than 20 percent. For example, if the proceeds of the bond are used to purchase assets with an average estimated economic life of 10 years, the maximum average maturity for the bonds may not exceed 12 years. The economic life of an asset is to be measured from the later of the date the bonds are issued or the date the assets are reasonably expected to be placed in service. Thus, in the above example, if the bonds are issued before the assets are placed in service, the maximum maturity for the bonds cannot exceed a date which is 12 years from the date the assets are expected to be placed in service. If, instead, the bonds are issued after the assets are placed in service, the maximum maturity cannot exceed a date which is 12 years from the date the assets are actually placed in service.

The rule restricting the maturity of IDBs applies to any obligations issued to refund previously issued obligations, regardless of whether the refunded obligations were issued before or after December 31, 1982. The maturity of the refunding obligations cannot be later than the maximum maturity date of the refunded obligations.

---

[7] The weighted average maturity of obligations of an issue is determined by taking into account the issue price (using concepts consistent with the rules in sec. 1232) of each obligation.

[8] The weighted average estimated economic life of assets financed with the proceeds of an issue is determined by taking into account the cost of each asset financed with the proceeds of the issue.

[9] Where the amount of the bond is less than the cost of the facilities, the assets financed with the bond shall include an allocable portion of the facilities which may be purchased by the bond proceeds under the bond indenture.

In general, the economic life of assets is to be determined on a case-by-case basis. However, in order to provide guidance and certainty, Congress intended that the administrative guidelines established for the useful lives used for depreciation prior to the enactment of the ACRS system (i.e., the midpoint lives under the ADR system where applicable and the guideline lives under Rev. Proc. 62-21, 1962-2 C.B. 418, in the case of structures) may be used to establish the economic lives of assets. However, the taxpayer can issue bonds with maturities longer than these administrative guidelines would allow if the taxpayer can show, on the basis of the facts and circumstances, that the economic life to the principal user or users of the facilities is greater than the lives established under these administrative guidelines.

Amendments to small issue exception

Termination of small issue exception

The Act provides that the small issue exemption will not apply with respect to obligations issued after December 31, 1986.

Limitation on single issues including "clean limit" small issue IDBs and other tax-exempt bonds

The Act provides that the $1 million "clean limit" small issue exception (sec. 103(b)(6)(A)) is not available for any IDB issued as part of a single issue with any other obligations, the interest on which is tax-exempt under any provision other than the small issue exception. For example, under the Act, if $21 million of IDBs were issued in connection with an airport facility where the interest on $20 million of the bonds was exempt under the exempt purpose exception for airports (sec. 103(b)(4)(D))[10] and the remaining $1 million of bonds were used to finance a non-exempt function facility, the interest on the bonds would not be exempt. Small issue IDBs issued under the alternative $10 million "capital expenditures" limitation (sec. 103(b)(3)(D)) will continue to be eligible for tax exemption if issued as part of a combined issue but only if the issuer elects to qualify the small issue IDBs for tax-exemption under that alternative limitation.

Elimination of small issue exception to finance certain facilities

The Act eliminates the small issue exception for bonds issued after December 31, 1982, if—

(i) more than 25 percent of the proceeds of the issue are to provide a facility the primary purpose of which is automobile sales or service, retail food and beverage services (including all eating and drinking places but not grocery stores), or the provision of recreation or entertainment; or

(ii) any portion of the proceeds of the issue is to be used to provide the following: any private or commercial golf course, country club, massage parlor, tennis club, skating facility (including roller skating, skateboard, and ice skating), racquet sports facility (including handball and racquetball courts), hot tub facility, suntan facility, or racetrack.

---

[10] This amount includes the so-called "insubstantial portion" of the proceeds which need not be used for the exempt function facilities.

The application of these limitations may be illustrated by the following example. Assume that a hotel is to be financed with an issue of small issue bonds and that the building contains a restaurant (which may or may not be operated in conjunction with the hotel). In determining whether 25 percent of the proceeds of the obligation are used for restricted purposes, the restaurant is treated as a prohibited use even though the restaurant may be considered functionally related and subordinate to the hotel. The cost of the restaurant would include a portion of the facilities used in common with the hotel operations such as parking, lobby, etc. On the other hand, the hotel rooms are not treated as a restricted use even though those rooms are occasionally used for eating and drinking since their primary purpose is used for lodging purposes.

The provision which restricts the use of small issue bonds does not affect bonds issued pursuant to other provisions (e.g., secs. 103(b) (4) and (5)). For example, assume that the facts are the same as the first example except the hotel is functionally related and subordinate to an airport which would qualify under section 103(b)(4)(D). In such a case, obligations issued to finance the hotel (including the restaurant) would be issued under section 103(b)(4) and, consequently, the rule restricting the use of small issue obligations would not apply. Similarly, obligations issued to finance a tennis facility that qualifies under section 103(b)(4)(B) are not affected by the restrictions prohibiting the use of small issue bonds for certain purposes.

Effective Dates

General rule

These provisions of the Act apply generally to obligations issued after December 31, 1982, including obligations issued solely to refund obligations outstanding on or before that date.

Public hearing and approval

The public hearing and approval requirement applies to obligations, including refunding issues, issued after December 31, 1982. However, under the exceptions to the public approval requirement, the public approval requirement does not apply to issues solely to refund a prior issue, which was issued before the public approval requirement became applicable, where the maturity of the bonds is not extended.

Restriction on cost recovery deductions

The restriction on the availability of accelerated cost recovery deductions for property with respect to which tax-exempt financing is provided applies generally to all such property placed in service after December 31, 1982.

However, the restrictions on cost recovery deductions do not apply to a facility placed in service after December 31, 1982, if the original use commences with the taxpayer and either—

(1) construction of the facility had commenced before July 1, 1982, or

(2) a binding contract existed on July 1, 1982, and at all times thereafter, which committed the purchaser to incur significant expenditures for construction or acquisition of the facility.

For purposes of the second exception, whether expenditures are significant may be determined by comparing the amount of the expenditures to the total anticipated cost of the facility.

Whether or not an arrangement between a purchaser and contractor or seller constitutes a contract is to be determined under the applicable local law. A binding contract is not considered to have existed on July 1, 1982, however, unless the property to be acquired or services to be rendered were specifically identified or described before that date.

A binding contract for purposes of this provision exists only with respect to property or services which the taxpayer is obligated to pay for under the contract. In addition, where a contract obligates a taxpayer to purchase a specified number of items and also grants him an option to purchase additional items, the contract is binding on the taxpayer only to the extent of the items he must purchase.

A contract may be considered binding on the taxpayer even though (a) the price of the item to be acquired or services rendered under the contract is to be determined at a later date, (b) the contract contains conditions the occurrences of which are under the control of a person not a party to the contract, or (c) the taxpayer has the right under the contract to make minor modifications as to the details of the subject matter of the contract.

A contract which was binding on a taxpayer on July 1, 1982, will not be considered binding at all times thereafter if it is substantially modified after that date. Additionally, a contract under which the taxpayer has an option to acquire property is not a contract that is binding on the taxpayer for purposes of this exception unless the amount paid for the option is forfeitable and is more than a nominal amount.

The restrictions on cost recovery deductions also do not apply to property placed in service after December 31, 1982, to the extent that the property is financed with tax-exempt bonds issued before July 1, 1982. For purposes of this exception, a refunding issue issued after June 30, 1982, generally is treated as a new issue and the taxpayer must use the slower recovery methods for unrecovered cost from the date of the refunding issue. If significant expenditures are incurred in respect of the facility before January 1, 1983, however, such a refunding issue will not be treated as a new issue and accelerated cost recovery methods may continue to be used. As with the exception for certain binding contracts, discussed above, whether expenditures are significant for purposes of this exception may be determined by comparing the amount of the expenditures to the total anticipated cost of the facility.

In cases where a change of recovery method is required because of a refunding issue, only the remaining unrecovered cost of the property is required to be recovered using the slower method and period. Therefore, no retroactive adjustments to cost recovery deductions previously claimed are required upon the refunding of a pre-July 1, 1982 issue where no significant expenditures are made with respect to the facility before January 1, 1983.

Finally, Congress intended that all property which is a part of the facilities described in the inducement resolution adopted before July 1, 1982, pursuant to which the bonds are issued, be treated as under construction where any part of those facilities is under construction before July 1, 1982. Moreover, Congress intended that all such property be included under the transitional rule even though part of the facilities are transferred by the taxpayer prior to their being placed in service and even though properties which are part of the facilities are placed in service before the completion of construction of other properties which are part of those facilities.

Amendments to small issue exception

Termination of small issue exception

The termination of the small issue exception applies to obligations issued after December 31, 1986.

"Clean limit"

The restrictions on the use of "clean limit" IDBs applies to bonds issued after the date of enactment.

b. Other amendments affecting industrial development bonds

(1) Tax exemption for industrial development bonds for facilities for the local furnishing of gas (sec. 217 of the Act and sec. 103(b)(4) of the Code)

Prior Law

Under both prior and present law, interest on State and local government obligations is generally exempt from Federal income tax. However, since 1968, tax exemption has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the denial of tax exemption for interest on IDBs applies in the case of IDBs which are used to provide facilities for certain exempt activities. Such facilities include facilities for the local furnishing of electric energy and gas (sec. 103(b)(4)(E)). A facility for the local furnishing of electric energy or gas is defined in Treasury regulations as property for the furnishing of electric energy or gas which is part of a system providing service to the general populace in a service area comprising no more than two contiguous counties (Treas. Reg. § 1.103-8(f)(2)(iii)). In the Revenue Act of 1978, the definition of a facility for the local furnishing of electric energy was modified to include also property for the furnishing of electric energy which is part of a system that provides electric energy to the general populace in a service area comprising no more than a city and one contiguous county.

Reasons for Change

Congress concluded that the same reasons that it had in 1978 for extending the exemption for the local furnishing of electricity to a service area consisting of no more than a city and a contiguous county also apply in the case of the local furnishing of gas.

Explanation of Provision

The Act provides that local furnishing of gas from a facility includes the furnishing solely within an area comprised of a city and one contiguous county. Thus, under the Act, tax-exempt financing is made available in the case of a facility for the furnishing of gas (which otherwise meets the requirements of sec. 103) provided that the service area of the facility comprises no more than two contiguous counties or a city and one contiguous county.

Effective Date

This provision applies to obligations issued after the date of enactment.

(2) Industrial development bonds for local district heating or cooling facilities (sec. 217 of the Act and secs. 103(b)(4) and (b)(10) of the Code)

Prior Law

Under both prior and present law, interest on State and local government obligations is generally exempt from Federal income tax. However, since 1968, tax exemption has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the denial of tax exemption for interest on IDBs applies in the case of IDBs which are used to provide facilities for certain exempt activities. Such facilities include facilities for the local furnishing of electric energy and gas (sec. 103(b)(4)(E)).

A facility for the furnishing of electric energy or gas is defined in Treasury regulations as property for the furnishing of electric energy or gas which is part of a system providing service to the general populace in a service area comprising no more than two contiguous counties. (Treas. Reg. § 1.103-8(f)(2)(iii)). In the Revenue Act of 1978, the definition of a facility for the local furnishing of electric energy was modified to include property for the furnishing of electric energy which is part of a system that provides electric energy to the general populace in a service area comprising no more than a city and one contiguous county.*

Reasons for Change

Congress believed that facilities which provide for local distribution of energy for heating and cooling through steam or water from a central energy source should be encouraged. In many respects, these facilities are analogous to facilities which provide for the local furnishing of electric energy or gas. Accordingly, Congress concluded that tax-exempt IDBs should be available to finance the facilities that distribute energy for heating or cooling in the form of water or steam on a local basis.

---

*Section 217 of the Act extends this rule to property for the local furnishing of gas.

Explanation of Provision

The Act exempts from tax interest on IDBs issued to finance local district heating or cooling facilities.

A local district heating or cooling facility includes equipment and other property used as an integral part of a local heating or cooling system, including pipes and piping, pipe insulation, valves, pumps, expansion systems, heat exchangers, temperature controls, terminal units, and meters, whether used by the producer, distributor, or consumer of local heating or cooling. The Act does not cover the facilities which produce the hot water, chilled water, or steam or facilities that are owned for tax purposes by a consumer. A local district heating or cooling system is any system consisting of a pipeline or network, which may include or be connected to a heating or cooling source, which provides hot water, chilled water, or steam to two or more users for residential, commercial, or industrial heating or cooling, or process steam, or for any combination of such purposes. For this purpose, a heating or cooling system is considered local if it has a service area comprised of no more than two contiguous counties or a city and one contiguous county.

Effective Date

This provision applies to obligations issued after the date of enactment.

(3) Exemption for certain multiple lot issues of industrial development bonds (sec. 214 of the Act and sec. 103(b)(6) of the Code)

Prior Law

Under both prior and present law, gross income does not include interest on obligations of a State or a political subdivision of a State (sec. 103(a)(1)). This exclusion does not apply, however, to interest on industrial development bonds (IDBs), unless the bonds fall within certain exceptions (sec. 103(b)). One of these exceptions provides that interest on IDBs which are part of an issue with a face amount of $1 million or less,[1] substantially all of the proceeds of which are to be used for the acquisition, construction, reconstruction, or improvement of land or depreciable property (referred to as small issue bonds), is exempt.

In certain cases, pooled offerings of bonds having an aggregate face value in excess of $1 million have been marketed as a single unit by the issuing authority or authorities. The pooled offerings have attributes of both a single bond issue and of a multiple lot of single bond issues. If viewed as a single bond issue, the bonds generally did not qualify for the small issue exception, and the interest paid on them was not, therefore, exempt from Federal income taxation under prior law.

In Revenue Ruling 81-216,[2] the Internal Revenue Service issued guidelines for determining whether a pooled offering of bonds was treated as a single bond issue or as a multiple lot issue. Under the ruling, this determination was stated to be factual, but such a pooled offering was generally treated as a single bond issue if the following factors were present:

---

[1] A $10 million limit applies if the issuer elects; however, in such cases, certain capital expenditures over a 6-year period are considered in determining whether the $10 million limit is exceeded.

[2] 1981-36 I.R.B. 6 (September 8, 1981).

(1) the bonds were sold at substantially the same time;

(2) the bonds were sold pursuant to a common plan of marketing;

(3) the bonds were sold at substantially the same rate of interest; and

(4) a common or pooled security was used or was available to pay debt service on the bonds.

On October 8, 1981, the Internal Revenue Service proposed regulations that provided essentially the same rules as Rev. Rul. 81-216 and proposed to revoke that revenue ruling.[3]

Reasons for Change

Congress believed that businesses should be able to obtain the cost savings of issuing tax-exempt small issue IDBs in multiple lots with tax-exempt small issue IDBs to be used by other unrelated businesses. However, Congress believed that multiple lot tax-exempt small issue IDBs should not be permitted if (1) the bonds finance facilities located in more than one State, (2) the bonds are financing more than one facility for any principal user of facilities, or (3) a single company is obtaining the benefit of such bonds indirectly as a franchisor.

Explanation of Provision

The Act provides that multiple lots of obligations will be treated as part of the same issue only if the proceeds of the obligations are to be used to finance two or more facilities which are located in more than one State or have the same principal users or principal users that are related persons. The term "principal user" generally has the same definition as that term under section 103(b)(6). However, for this purpose, a principal user also includes a person (other than a governmental unit) which (1) either guarantees directly or indirectly the repayment of obligations or aids in arranging the issuance of the obligations and (2) provides property,[4] franchise, trademark, or trade name to be used in connection with the facilities financed with the obligations.

Whether obligations meet any of these tests is to be determined under the facts and expected uses as of the date that the obligations are issued. Thus, interest on obligations which originally did not meet any of these tests will not lose its exemption because facilities financed by the obligations are moved out of the State or because principal users of two facilities financed by the obligations subsequently become related, so long as these events were not expected at the time of the issuance of the bonds.

Under the Act, lots of obligations which are not treated as a single issue pursuant to the transitional rules adopted by the Internal Revenue Service for the rule provided in Rev. Rul. 81-216 are not considered as a single issue and, thus, are not subject to the rules of the Act on multiple lot IDBs.

---

[3] 46 Fed. Reg. 50014 (October 8, 1981).

[4] For this purpose, property does not include a letter of credit.

Effective Date

The provision is effective for obligations issued after the date of enactment.

(4) Exclusion of certain research expenses from capital expenditure limitation for small issue industrial development bonds (sec. 214 of the Act and sec. 103(b)(6) of the Code).

Prior Law

Under both prior and present law, interest on certain "small issue" industrial development bonds (IDBs) is exempt from Federal income tax if the aggregate amount of outstanding exempt small issues and capital expenditures (financed otherwise than out of the proceeds of an exempt small issue) made over a six-year period does not exceed $10 million (sec. 103(b)(6)).

Under prior law, research or experimental expenditures incurred in connection with a taxpayer's trade or business were taken into account for purposes of determining if the small issue limitation of $10 million was exceeded, whether or not the taxpayer elected (under sec. 174(a)) to deduct currently such research expenses.

Reasons for Change

Congress believed that research and development expenditures should be encouraged. The prior law rule that required research and development expenditures to be counted in meeting the $10 million limitation could provide a substantial impediment to firms using small issue IDBs and incurring certain research and development costs. Consequently, Congress believed that research and development expenditures of a type for which the credit for research and development may be allowable should not be counted in determining whether the $10 million capital expenditure limitation is met. Moreover, Congress believed that such a rule is consistent with the purpose of the $10 million limitation of restricting the size of projects which may be financed with small issue bonds because the size of a project is not affected by the amount of research and development expenses for supplies and salaries.

Explanation of Provision

Under the Act, expenditures for research wages or for research supplies (as defined in secs. 44F(b)(2)(A)(i) or (ii)) which the taxpayer elects to deduct currently (under sec. 174(a)) are not taken into account for purposes of the $10 million capital expenditure limitation on tax-exempt small issue industrial development bonds.

Effective Date

The provision applies to research wage and supply expenditures paid or incurred after the date of enactment.

(5) IDBs for multi-family residential rental projects (sec. 221 of the Act and secs. 103(b)(4) and (b)(12) of the Code)

Prior Law

Under both prior and present law, tax-exempt industrial development bonds could be used for multi-family rental projects only if 20 percent of the units (15 percent in targeted areas) were occupied by individuals of "low or moderate income." Under prior law, the definition of "low or moderate income" was defined by reference to the meaning of that term under section 8 of the United States Housing Act of 1937. In addition, the 20-percent requirement (15 percent in targeted areas) had to be met for 20 years with respect to any obligations issued before January 1, 1984.

Reasons for Change

Congress believed that certain of the rules relating to the use of tax-exempt IDBs for rental housing needed to be clarified. Specifically, Congress believed that the definition of persons of low or moderate income needed to be clarified in light of the changes to the section 8 program adopted by Congress in 1981. In addition, Congress believed that it should provide a permanent rule on the length of time that units in a rental project must be occupied by persons of low or moderate income.

Explanation of Provision

The Act makes two changes in the rules for IDBs used to finance residential rental property for low and moderate income families. First, the Act provides a separate definition of individuals of low and moderate income by adopting the definition of that term under the section 8 program except that the applicable percentage will be 80 percent of the area median income (regardless of the percentage used under the section 8 program).

Second, the duration of the requirement that 20 percent (15 percent in targeted areas) of the housing units in a project be occupied by individuals of low or moderate income is changed. Under the Act, that rule applies from the date 10 percent of the project is first occupied and continues until the latest of (1) 10 years after over one-half of the project is first occupied, (2) a date ending when 50 percent of the maturity of the bonds having the longest maturity has expired, or (3) the date on which any section 8 (or comparable) assistance terminates. As under prior law, all of the units of the project financed with tax-exempt IDBs must remain as rental units for the length of the targeting requirement.

Effective Date

The changes to the requirements for IDBs for low and moderate income residential rental property apply to obligations issued after the date of enactment other than obligations which are exempt from the restrictions of the Mortgage Subsidy Bond Tax Act of 1980.

(6) Advance refunding of certain IDBs of the Port Authority of St. Paul (sec. 218 of the Act)

Prior Law

Under both prior and present law, interest on State and local government obligations is generally exempt from Federal income tax. However, since 1968, tax exemption generally has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

Under both prior and present law, advance refundings of IDBs generally are prohibited. However, advance refundings are permitted for IDBs for certain convention and trade show facilities, airports, docks, wharves, and mass commuting facilities (sec. 103(b)(7)).

Advance refunding issues are bonds issued more than 180 days prior to the retirement of the original bonds. Thus, in an advance refunding, both the original issue and the refunding issue remain outstanding.

Reasons for Change

Congress believed that the Port Authority of St. Paul should be permitted to advance refund certain IDBs, but only if the refunded obligations are retired as soon as economically practicable.

Explanation of Provision

The Act provides that certain IDBs of the Port Authority of St. Paul, Minnesota, may be advance refunded as long as the refunded obligations are retired within six months after any call premium on the refunded bonds lapses.

Effective Date

This provision is effective on the date of enactment.

(7) Regional pollution control facilities (sec. 217 of the Act and sec. 103(b)(11) of the Code)

Prior Law

Under both prior and present law, interest on State and local government obligations is generally exempt from Federal income tax. However, since 1968, tax exemption generally has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

Both prior and present law generally prohibited the issuance of IDBs to acquire existing facilities if a substantial user of the facilities prior to the acquisition would be a substantial user after the acquisition.

Reasons for Change

Congress believed that tax-exempt financing should be available for the acquisition by a pollution control authority of used pollution control facilities in cases where the pollution control authority issuing the bonds will operate the acquired facilities and there are restrictions which insure that the benefits of tax-exempt financing do not accrue to the seller of the facilities.

Explanation of Provision

The Act permits tax-exempt IDBs to be issued, under certain conditions, for use by a regional pollution control authority to acquire existing air or water pollution control facilities which the authority itself will operate in order to maintain or improve the control of pollutants. These conditions are (1) that the purchase price of the facilities cannot exceed their fair market value, (2) the fees charged for use of the facilities after the sale are not less than the amounts that would have been charged had taxable financing been used, and (3) that no person, other than the authority, be considered the owner of the facilities for Federal income tax purposes.

Effective Date

This provision applies to obligations issued after the date of enactment.

(8) Modification of definition of qualified mass commuting vehicle (sec. 217 of the Act and secs. 103(b) and (q) of the Code)

Prior Law

Under both prior and present law, interest on State and local government obligations is generally exempt from Federal income tax. However, since 1968, tax exemption generally has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the general rule governing taxation of interest on IDBs permits tax-exemption of interest on IDBs used to finance qualified mass commuting vehicles. Under prior law, qualified mass commuting vehicles were defined as buses, rail cars, or similar equipment which is leased to a governmentally-owned mass transit system and used in providing mass commuting services.

Reasons for Change

Congress believed that tax-exempt IDBs should be available to finance ferry boats.

Explanation of Provision

The Act expands the types of mass commuting vehicles eligible for tax-exempt financing to include ferries engaged in providing mass transportation services.

Effective Date

The provision applies to obligations issued after the date of enactment.

c. Amendments to the Mortgage Subsidy Bond Tax Act (sec. 220 of the Act and sec. 103A of the Code)

Prior Law

Overview

The Mortgage Subsidy Bond Tax Act of 1980 was enacted as part of the Omnibus Reconciliation Act of 1980 (Pub. L. 96–499). The Act was intended generally to direct the subsidy from the use of tax-exempt bonds for housing to those individuals who have the greatest need for the subsidy, to increase the efficiency of the subsidy, and to restrict the overall revenue loss from the use of tax-exempt bonds for housing. In order to achieve these goals, the 1980 Act imposed a number of restrictions on the issuance of tax-exempt bonds for financing owner-occupied housing. The restrictions modified by the this Act are the three-year requirement, the purchase price requirement, and the arbitrage limitation.

Three-year requirement

Under prior law, in order for an issue to be a qualified mortgage issue, all of the mortgages financed from the bond proceeds were required to be provided to mortgagors each of whom did not have a present ownership interest in a principal residence at any time during the three-year period ending on the date that the mortgage was executed.

The three-year requirement does not apply with respect to mortgagors of residences in three situations. First, it does not apply to mortgagors of residences that are located in targeted areas. Second, it did not apply to mortgagors who receive qualified home improvement loans. Third, it does not apply to mortgagors who receive a qualified rehabilitation loan.

Purchase price requirement

Under prior law, in order for an issue to be a qualified mortgage issue, all of the mortgages (or other financing) provided from the bond proceeds, except qualified home improvement loans, were required to be for the purchase of residences where the acquisition cost of each residence did not exceed 90 percent (110 percent in targeted areas) of the average area purchase price applicable to that residence.

Arbitrage limitation

In order for an issue to be a qualified mortgage issue, the issue is required to meet certain limitations regarding arbitrage as to both mortgage loans and nonmortgage investments.

Mortgage investments

Under prior law, the effective rate of interest on mortgages provided under an issue could not exceed the yield on the issue by more than one percentage point. This determination was made on a composite basis for all mortgages under the issue. Consequently, the effective interest rate on some mortgages could be greater than one percentage point above the yield of the issue if other mortgages had a lower effective interest rate.

Nonmortgage investments

The 1980 Act also imposed restrictions on the arbitrage on nonmortgage investments. Mortgage subsidy bonds usually have established a reserve to secure payment of the debt service on the bonds. The 1980 Act provided that the reserve must be reduced as future annual debt service is reduced.

The 1980 Act also limited the amount that could be invested as unrestricted yield in nonmortgage investments to 150 percent of the debt service on the issue for the bond year. An exception to the 150-percent debt service rule was provided, however, for proceeds invested for an initial temporary period until such proceeds were needed for mortgages.

The 1980 Act also required that arbitrage earned by the issuer on nonmortgage investments be paid or credited to the mortgagors or paid to the Federal Government.

Reasons for Change

Congress was concerned over the present distressed state of the housing industry. In light of the fact that the mortgage subsidy bond program is scheduled to terminate on December 31, 1983, Congress believed that relaxation of some of the limitations in the Mortgage Subsidy Bond Tax Act of 1980 would be the most effective and least costly method of providing temporary aid to that industry. Relaxation of the arbitrage limitation, three-year requirement, and purchase price requirement should ensure that the volume of mortgage subsidy bonds will increase toward the maximum volume restrictions permitted under the law.

Congress provided these changes from prior law because of the temporarily distressed state of the housing industry, even though the changes might reduce the effect of the restrictions of the Mortgage Subsidy Bond Tax Act to direct the benefits of tax-exempt bonds to persons of the greatest need. Nonetheless, Congress expected that State and local issuers will exercise their discretion in the use of mortgage subsidy bonds so as to implement the basic purposes of the Mortgage Subsidy Bond Tax Act as much as practicable.

In addition, Congress desired to clarify the application of the rules of the 1980 Act to financing of cooperative housing corporations. Congress believed that cooperative housing corporations should be eligible for tax-exempt financing under the rules applicable to owner-occupied housing.

11-324 O - 83 - 9

Explanation of Provisions

Three-year requirement

The Act modifies the three-year requirement to provide that at least 90 percent (instead of 100 percent as under prior law) of the lendable proceeds (i.e., bond proceeds less issuance expenses and reserves) of the issue must be loaned to mortgagors who meet the three-year requirement. The 90-percent test is to be computed by excluding any financing with respect to targeted area residences, any qualified home improvement loan, and any qualified rehabilitation loan.

Purchase price limitation

The Act increases the purchase price limitation from 90 percent (110 percent in targeted areas) of the average area purchase price to 110 percent (120 percent in targeted areas).

Arbitrage

Mortgage investments

The effective rate of interest on mortgages financed with tax-exempt bonds may not exceed the yield on the issue by more than 1⅛ (1.125) percentage points. The Act clarifies that, in determining the effect of prepayments of mortgage principal on the computation of the effective rate of mortgage interest, prepayments of principal shall be treated as received on the last day of the month in which the issuer reasonably expects to receive such prepayments.

Nonmortgage investments

The Act provides that the rule requiring liquidation of nonmortgage investments with a yield higher than the issue yield will not apply to the extent that it would require disposition of any nonmortgage investment resulting in a loss in excess of the amount of undistributed arbitrage profits in nonmortgage investments at such time. However, the rule will continue to apply if the sale of such nonmortgage investments would not result in a loss when the investments are sold to meet the liquidation rule. Similarly, the rule will apply if loss assets subsequently appreciate so that their sale or exchange would not result in a loss.

Cooperative housing corporations

In the case of any cooperative housing corporation (as defined in Code sec. 216), each dwelling unit shall be treated, for purposes of applying the restrictions applicable to tax-exempt financing of owner occupied housing (sec. 103A), as if it were actually owned by the person entitled to occupy that unit by reason of his or her ownership in the cooperative housing corporation. In addition, any indebtedness of the corporation that is allocable to the dwelling unit shall be treated as if it were indebtedness of the shareholder who is entitled to occupy the dwelling unit. Thus, the acquisition cost for a cooperative unit includes a proportionate share of the underlying blanket mortgage plus the purchase price of the shares.

The Act provides that any issue that provides financing to a cooperative housing corporation that is not located in a targeted area may be combined with one or more other issues which in sum satisfy the requirement that at least 20 percent of the proceeds of the issues will be devoted to owner-financing of residences in targeted areas for a period of at least one year.

In addition, loans to cooperative housing corporations for rehabilitation may qualify for tax-exempt financing under section 103A(l)(7) to the same extent as if each shareholder receives a proportionate share of the loan. In the case of tax-exempt financing used for the construction of a residential building owned by a cooperative housing corporation, unlimited arbitrage otherwise allowed during an initial 3-year temporary period would be permitted for only one year.

Finally, Congress clarified that tax-exempt financing may be allowable under section 103(b)(4)(A) where a cooperative housing corporations leases property from another person and the shareholders of the cooperative meet the targeting provisions of that section.

Effective Dates

Except for the modifications to the three-year requirement, the provisions are effective for bonds issued after the date of enactment. The modification to the three-year requirement is effective for bonds issued after April 25, 1979, to the extent that proceeds have not been committed to mortgagors by date of enactment.

d. Revenue effect of tax-exempt bond provisions

The provisions affecting tax-exempt bonds are expected to increase fiscal year budget receipts by $63 million in 1983, $261 million in 1984, $539 million in 1985, $748 million in 1986, and $1,076 million in 1987.

9. Mergers and Acquisitions

a. Partial liquidations (sec. 222 of the Act and secs. 331, 336, and 346 of the Code)[*]

Prior Law

Generally, under prior law, the basis of assets received by a shareholder in a partial liquidation was their fair market value at the time of distribution, the distribution did not result in the recognition of gain or loss to the distributing corporation, and the transaction was treated as a sale or exchange of their stock by the distributee shareholders resulting in capital gain or loss to them.

A partial liquidation was a distribution by a corporation to its shareholders in redemption of the corporation's stock pursuant to a plan if it was one of a series of distributions in redemption of all of the corporation's stock or it was not essentially equivalent to a dividend and if it occured within the taxable year in which the plan was adopted or the succeeding year.

In determining that a distribution was not essentially equivalent to a dividend in applying the tests for a partial liquidation, generally a contraction of the corporation's business was required. A distribution could constitute a partial liquidation even though it was made pro rata among the corporation's shareholders.

If the distribution consisted of the assets of, or was attributable to the corporation's ceasing to conduct, a trade or business that was conducted for 5 years or more before the distribution and was not, within the 5-year period, acquired by the corporation in a taxable transaction and if the corporation, after the distribution, continued to conduct another trade or business with a similar history, the distribution was treated as a partial liquidation.

No gain or loss to the distributing corporation was recognized on a distribution in a partial liquidation (sec. 336(a)) except for dispositions of installment obligations and distributions of LIFO inventory. In addition, the various recapture rules of present law override sec. 336. Thus, the corporation had to include in income depreciation recapture (secs. 1245 and 1250), certain intangible drilling and development costs (sec. 1254), and other recapture items with respect to the distributed property. This general nonrecognition treatment can be contrasted with the result if the corporation, rather than distributing assets, sold the assets and distributed the proceeds to its shareholders in a partial liquidation, in which case gain or loss was recognized to the corporation on the sale.

---

[*] For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 226; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 186-188; Committee amendment 128 Cong. Rec. S8643-8645 (July 19, 1982); Senate floor amendments, 128 Cong Rec. S8974-5 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 528-532 (Joint Explanatory Statement of the Committee of Conference). Also, see H.R. 6056, as reported by the Senate Finance Committee, sec. 306, S. Rep. No. 97-592 (Sept. 27, 1982), p. 52.

Shareholders receiving a distribution in partial liquidation were treated as receiving the amount distributed in exchange for their stock and, if the stock redeemed in the transaction was a capital asset to the shareholder, capital gain or loss resulted from the transaction.

If the distributor and the distributee shareholder were affiliated corporations filing a consolidated return, a partial liquidation resulted in additional tax benefits. Under the consolidated return regulations, recapture income was deferred, generally until the distributed property resulted in depreciation deductions to the distributee or the property was disposed of outside the consolidated group. Further, under those regulations, there is generally no investment tax credit recapture when property is transferred from one member of the group to another. The basis of assets distributed in the partial liquidation was determined by reference to the basis for the stock treated as exchanged in the transaction. Thus, in the case of a newly-acquired subsidiary, the distributed property was essentially treated as purchased for the price paid for such stock but there was no investment tax credit recapture and other recapture items were deferred.

Reasons for Change

The partial liquidation rules of prior law allowed unwarranted advantages when one corporation acquired control of another. A stepped-up basis for selected assets with little or no immediate tax consequences could be combined with a continuation of the acquired entity, as long as a distribution of the selected assets satisfied the corporate contraction standard. Congress believed that the partial liquidation provisions of prior law offered corporate purchasers of stock an inappropriate choice to treat the transaction as a continuation of the acquired corporation for tax purposes while also treating a distribution by it of selected assets as a purchase of those assets, the sale of which resulted in little or no tax consequences to the acquired corporation. Congress also believed that avoidance or deferral of the tax consequences normally incident to a sale of assets under the consolidated return regulations relating to partial liquidations was inappropriate.

Congress believed that a rule permitting capital gain treatment should be retained for distributions in partial liquidation to noncorporate shareholders. However, in this as in other cases covered by the Act, Congress believed that where a redemption of stock for property involves a continuing corporation and where the redemption is treated as a taxable exchange by the shareholders, it should generally be treated as a taxable exchange by the corporation. As an exception to the general rule, Congress believed that nonrecognition to the distributing corporation, as under prior law, should be preserved for partial liquidation distributions to substantial noncorporate shareholders who had held stock in the corporation for a substantial period.

Explanation of Provision

The Act modifies the treatment of partial liquidations. Only noncorporate shareholders are treated as receiving the amount distributed in exchange for their stock. Distributions to corporate shareholders are governed by the provisions of prior law other than those relating to partial liquidations.

The Act adds a new section 302(b)(4) under which distributions in redemption of a noncorporate shareholder's stock are treated as payments in exchange for the stock under section 302(a) if such distributions are in partial liquidation of the distributing corporation. For this purpose, a partial liquidation is defined in new section 302(e) which continues the definition of a partial liquidation in prior law section 346(a)(2) and section 346(b), which are repealed by the Act. As under prior law section 346(a)(2), the determination that a distribution is not essentially equivalent to a dividend for purposes of satisfying the partial liquidation definition is to be made with reference to the effect of the transaction on the distributing corporation and not with reference to its effect at the shareholder level. The corporate level determination of dividend equivalence is made an explicit statutory test under the Act.

Under prior law, a distribution in partial liquidation may take place without an actual surrender of stock by the shareholders. *Fowler Hosiery Co.* v. *Commissioner,* 301 F.2d 394 (7th Cir. 1962). A constructive redemption of stock is deemed to occur in such transactions (Rev. Rul. 81-3, 1981-1 C.B. 125). Congress intended that this treatment of partial liquidations under prior law sections 346(a)(2) and (b) is to continue for such transactions under new section 302(e). Gain may be recognized to the distributing corporation under section 311(d) as amended by the Act notwithstanding the absence of an actual surrender of stock by the shareholders, if the distribution qualifies as a partial liquidation under new section 302(e) without an actual surrender of stock.

Whether or not a redemption is treated as a distribution in partial liquidation is determined without regard to whether the redemption is pro rata with respect to all the shareholders of the corporation. A distribution in partial liquidation, pursuant to section 302(b)(4), will be treated as a distribution in exchange for stock under section 302(a) without regard to whether the redemption satisfies the requirements of paragraphs (1), (2), or (3) of section 302(b). A distribution in partial liquidation that also terminates a shareholder's interest in the corporation will be treated as a distribution in exchange for stock under section 302(a) without regard to section 302(c)(2).

Generally, under the Act, gain is recognized to a corporation distributing appreciated property in partial liquidation to a noncorporate shareholder, under section 311(d) as amended by the Act. An exception is provided when the distribution is made with respect to qualified stock. Qualified stock is stock that has been held by certain noncorporate shareholders for the 5-year period ending on the date of distribution or (if less) for the period the corporation has been in existence. The period a distributing corporation has been in existence includes the period of existence of a predecessor corporation. The shareholder must have held at least 10 percent in value of the distributing corporation's stock throughout such period. The constructive ownership rules of section 318 apply in determining ownership. In applying the attribution rules of section 318(a)(1), the group of persons among whom ownership is attributed is expanded to include individuals described in section 267(c)(4) and the spouses of such individuals.

Under this rule, it is not required that the stock redeemed be held by the shareholder for five years. It is sufficient that the shareholder hold (or be treated as holding) 10 percent of the stock throughout the five-year period.

For purposes of determining whether stock is held by a shareholder who is not a corporation in applying new section 302(b)(4), stock held by a partnership, estate, or trust will be treated as if it were actually held proportionately by its partners or beneficiaries.

As under prior law, distributions in partial liquidation that are treated under section 302(a) as distributions in exchange for stock pursuant to new section 302(b)(4) will be subject to the collapsible corporation rules of section 341.

A distribution that is one of a series in redemption of all the stock of a corporation, defined as a partial liquidation in prior law, is defined as a complete liquidation under the Act.

The Act authorizes the Secretary of the Treasury to prescribe regulations, where necessary, to ensure that repeal of the provision providing special treatment of partial liquidations will not be circumvented through the use of other provisions of present law or regulations, including the consolidated return regulations. It is contemplated that such regulations may treat a corporation as continuing and characterize any distribution accordingly where a transaction is in form a complete liquidation but business operations are continued in corporate solution as a result of a spin-off or other tax-free transfer by the liquidating corporation. For example, a corporation may transfer to a newly-formed subsidiary corporation a trade or business and distribute the stock of such corporation to its shareholders in a transaction qualifying for nonrecognition of gain under section 355. If there is a subsequent distribution of a retained trade or business and all its other properties by the distributing corporation, such regulations may treat the subsidiary corporation as a continuation of the distributor and the distribution by the latter of all its properties other than those contributed to the subsidiary corporation as a distribution other than a distribution in complete liquidation.

The Act was not intended to affect the treatment under prior law of any distribution which is in substance a sale of assets.

Effective Date

The Act generally applies to distributions in partial liquidation after August 31, 1982. Distributions continue to be covered by prior law rules governing the treatment of partial liquidations under the following exceptions to the general effective date provision:

(1) A ruling that partial liquidation treatment applied to a transaction was granted by the Internal Revenue Service within the period beginning on July 12, 1981, and ending on July 22, 1982 (or a ruling request as to such treatment was pending on July 22, 1982) and the plan of partial liquidation was adopted before October 1, 1982 or, where a ruling request was pending on July 22, 1982, within 90 days after the ruling was granted. A request will be treated as pending on July 23, 1982, and thereafter notwithstand-

ing that, pursuant to negotiations with the Internal Revenue Service, a revision or modification of the request is filed or additional information is submitted.

(2) A plan of partial liquidation was adopted before July 23, 1982.

(3) Control of the distributing corporation was acquired after December 31, 1981, and before July 23, 1982, and the plan of partial liquidation was adopted before October 1, 1982.

(4) Control of the distributing corporation is acquired after July 22, 1982, pursuant to a tender offer or binding contract outstanding on such date. The plan of partial liquidation must be adopted before the later of October 1, 1982, or, if the acquisition is subject to approval by a Federal regulatory agency, the date which is 90 days after the date on which such approval becomes final in accordance with law. A public announcement of an offer to acquire stock will be treated as a tender offer for purposes of this exception if the offer has resulted in intervention by a foreign regulatory body before which the proposal was pending before July 23, 1982, and the plan of partial liquidation is adopted within 90 days after the date on which the foreign regulatory body approves of the offer. In addition, this exception applies although no binding contract or tender offer was outstanding on July 22, 1982, if, during March and April 1982, one-third or more of the shares of a corporation were acquired and the intention to acquire control was evidenced by documents filed with the Federal Trade Commission and if control was thereafter acquired.

(5) Control of an insurance company was acquired after December 31, 1980, and before July 23, 1982, where the conduct of the insurance business by the distributee corporation is conditioned on approval by one or more State regulatory authorities. This exception applies if control was acquired either by the distributee corporation or its parent. A plan of partial liquidation must be adopted before October 1, 1982.

"Control" for purposes of the exceptions means control as defined in section 368(c) of the Code. As amended by the Technical Corrections Act of 1982, this definition includes indirect control. Thus, if control of a corporation was acquired in 1982 before July 23, 1982, and a plan of partial liquidation of a wholly owned subsidiary of the acquired corporation was adopted before October 1, 1982, prior law applies to the liquidation. Control is acquired after July 22, 1982, even if an amount of stock constituting less than control was held on such date.

For purposes of these exceptions, a plan of partial liquidation is treated as adopted on the date on which it is approved by the corporation's board of directors. Such date is also to be treated as the date of adoption of a plan for purposes of determining the period within which distributions under the plan must be made in applying section 346(a)(2) (as in effect before its repeal by the amendments made by the Act).

A contract will be treated as a binding contract for purposes of applying the exceptions if it is binding on the acquiring corporation and even though it is subject to approval by a vote of the shareholders, the obtaining of financing to consummate the acquisition and other similar conditions.

Property acquired in distributions to which these exceptions apply will be treated as property acquired before September 1, 1982, in applying the rules of new section 338 requiring consistency of treatment for acquisitions of stock and assets in certain cases.

b. Certain distributions of appreciated property (sec. 223 of the Act and sec. 311(d) of the Code)*

Prior Law

When a corporation in a nonliquidating distribution distributes property, the value of which exceeds its basis, in redemption of a portion of the corporation's stock, gain is recognized as though the property were sold (sec. 311(d)(1)). Prior law excepted several types of transactions from this treatment.

Exceptions were provided for (1) distributions that terminate the interest of a shareholder who has held at least 10 percent of the corporation's stock for a 12-month period; (2) distributions that consist of stock or obligations in a subsidiary conducting a trade or business that was at least 50 percent owned by the distributing corporation at any time within the preceding 9 years; (3) distributions that consist of stock or securities distributed pursuant to certain anti-trust decrees; (4) distributions to which section 303(a) (relating to distributions in redemptions of stock to pay death taxes) applies; (5) certain distributions to private foundations; (6) certain distributions by regulated investment companies; and (7) certain distributions pursuant to the Bank Holding Company Act.

Notwithstanding these exceptions, a transaction that was in form a stock redemption could be treated as a direct sale of assets where the stock ownership was transitory (see Rev. Rul. 80-221, 1980-2 C.B. 107).

Reasons for Change

A direct sale of property by a corporation and a distribution of property in a stock redemption may be economically equivalent events whether or not the ownership of the stock is transitory. Accordingly, Congress believed that these transactions should be treated symmetrically.

Congress also believed that, under prior law, certain exceptions to the rule that a corporation recognizes gain when it distributes appreciated property in a stock redemption placed an unwarranted premium on making an acquisition through a purchase and subsequent redemption of stock in exchange for the desired property. Congress believed that generally, except for certain business-related distributions to substantial, long-term shareholders, such distributions should be treated as taxable exchanges by the corporation.

At the time Congress enacted section 311(d)(1) and the exceptions thereto, the Conference Committee requested the Treasury Department and Congressional staffs to analyze the provision to see whether any tax avoidance possibilities still remained. Congress believed that the existence of certain of the exceptions resulted in avoidance possibilities.

---

* For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 227; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 1189-90; (Committee amendment, 128 Cong. Rec. S. 8643-8645 (July 19, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 532-535. (Joint Explanatory Statement of the Committee of Conference). Also, see H.R. 6056, Senate floor amendments, 128 Cong. Rec. S. 12737.

Explanation of Provision

The Act repeals the exceptions in section 311(d)(2) for distributions terminating the interest of a shareholder who has held 10 percent or more of the corporation's stock for one year, for distributions pursuant to antitrust decrees, and for distributions pursuant to the Bank Holding Company Act, and it modifies the exception for distributions of stock or obligations of a subsidiary.

The Act was not intended to affect the treatment under prior law of distributions that are in substance the purchase of assets.

The Act revises subparagraphs (A), (B), and (C) of section 311(d)(2) to conform the treatment of the distributing corporation to the new rules applicable to partial liquidations and to provide for nonrecognition of gain when stock or obligations of a subsidiary are distributed in redemption of stock in certain transactions analogous to a partial liquidation.

New section 311(d)(2)(A) provides for nonrecognition of gain to the distributing corporation in any case where the basis of property distributed to a corporate shareholder is determined under section 301(d)(2). Distributions in partial liquidation to a corporate shareholder generally will be treated similarly to distributions which are not in redemption of stock unless they are non-pro rata distributions to which section 302(b) (1), (2), or (3) applies. Such distributions generally will be treated as dividends or other distributions to which section 301(d)(2) applies. Gain is not recognized to a distributing corporation on such section 301 distributions that are not in redemption of stock and the revised section 311(d)(2)(A) conforms the treatment of the distributing corporation to the treatment of a corporate shareholder on partial liquidation distributions whether or not there is an actual surrender of stock in the transaction.

Section 311(d)(2)(B) provides for nonrecognition of gain to the distributing corporation on distributions in partial liquidation to which new section 302(b)(4) applies which are made with respect to qualified stock.

Section 311(d)(2)(C) provides the exception to gain recognition for distributions of stock or obligations of a corporation (hereinafter called the controlled corporation).

For the exception with respect to distributions of stock or obligations of a controlled corporation to apply, the distribution must be made with respect to qualified stock and more than 50 percent in value of the controlled corporation's stock must be distributed with respect to qualified stock. The Act further requires that substantially all the assets of the controlled corporation consist of the assets of one or more qualified businesses and that no substantial part of the controlled corporation's nonbusiness assets be acquired from the distributing corporation in transactions to which section 351 applies or as a contribution to capital within the 5 years ending on the date of distribution.

A qualified business is one that was actively conducted throughout the 5-year period ending on the date of distribution and was not acquired within such period by any person in a transaction in which gain or loss was recognized in whole or in part. Section 355, relating to distributions of stock or securities of a controlled corporation, contains a similar active business requirement.

Nonbusiness assets are defined to include any asset not used in the active conduct of a trade or business. For this purpose, cash and other items that provide working capital needs of an active business will be treated as assets used in the active conduct of the business.

Effective Date

The repeal of prior law section 311(d)(2) exceptions is effective for distributions made after August 31, 1982. However, the Act retains the exceptions in sections 311(d)(2)(A) and 311(d)(2)(C) of prior law for certain distributions made on or after September 1, 1982. Section 311(d)(2)(A) of prior of law continues to be applicable to distributions made either before October 21, 1982, pursuant to a ruling, or within 90 days after a ruling is granted, if a ruling request was made on or before July 22, 1982 with respect to the application of section 311(d)(2)(A) to a proposed distribution. Also prior law section 311(d)(2)(A) continues to apply to distributions, otherwise qualifying for such treatment, which are made on or before August 31, 1983, with respect to stock acquired after 1980 and before May 1982.

Finally, the redemption of preferred and common stock by a forest products company pursuant to a binding contract in effect on August 31, 1982, and at all times thereafter, where all distributions must be pursuant to one of the two options set forth in the contract will continue to be subject to prior section 311(d)(2)(A) to the extent timberland is distributed to the shareholder (with a value of not more than $10 million on August 31, 1982).

The Act makes section 311(d)(2)(C) of prior law applicable to distributions before January 1, 1986, of stock or securities pursuant to a judgment entered before July 23, 1982.

c. Stock purchases treated as asset purchases (see 224 of the Act and sec. 338 of the Code)*

Prior Law

Upon the complete liquidation of a subsidiary corporation, 80 percent of the voting power and 80 percent of the total number of shares of all other classes of stock (other than nonvoting preferred stock) of which is owned by the parent corporation, gain or loss is generally not recognized and the basis of the subsidiary's assets and its other tax attributes are carried over (secs. 332, 334(b)(1), and 381(a)).

Under prior law, however, if the controlling stock interest was acquired by purchase within a 12-month period and the subsidiary was liquidated pursuant to a plan of liquidation adopted within 2 years after the qualifying stock purchase was completed, the transaction was treated as in substance a purchase of the subsidiary's assets (sec. 334(b)(2)). The acquiring corporation's basis in the "purchased" assets was the cost of the stock purchased as adjusted for items such as liabilities assumed, certain cash or dividend distributions to the acquiring corporation, and postacquisition earnings and profits of the subsidiary. The liquidating distributions could be made over a 3-year period beginning with the close of the taxable year during which the first of a series of distributions occurs (sec. 332(b)(3)). Thus, this treatment applied even though the liquidation could extend over a 5-year period after control had been acquired.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 229; Rep. No. 97-494, Vol. 1 (July 12, 1982), pp.191-197; Committee amendment, 128 Cong. Rec. S. 8643-4 (July 19, 1983); and H. Rep. No. 97-760 (August 17, 1982), pp. 535-540 (Joint Explanatory Statement of the Committee of Conference.) Also, see H.R. 6056, as reported by the Senate Finance Committee, sec. 306, S. Rep. No. 97-592 (Sept. 27, 1982), pp. 51-52; House floor amendments, 128 Cong. Rec. H9600-9604; H. Rep. No. 97-986 (Dec. 21, 1982), pp. 22-24 (Joint Explanatory Statement of the Committee of Conference).

In these cases, when the assets were treated as purchased by the acquiring corporation, recapture income was taxed to the liquidating corporation, the investment tax credit recapture provisions were applicable, and tax attributes, including carryovers, of the liquidated corporation were terminated.

Cases interpreting the law applicable before the rules in section 334(b)(2) were adopted, treated the purchase of stock and prompt liquidation in some cases as a purchase of assets (*Kimbell-Diamond Milling Co.* v. *Commissioner* 14 T.C. 74, aff'd per curiam, 187 F2 718 (5th Cir.), cert. denied, 342 US 827 (1951)). It is not clear whether such treatment still applied after the enactment of section 334(b)(2) in cases where the requirements of that provision were not met.

A stock purchase and liquidation was treated as a purchase of all the assets of the acquired corporation under prior law if section 334(b)(2) applied. Revision of the special treatment of partial liquidations under the Act restricts the options of a corporate purchaser seeking to treat a purchase of a corporation as a purchase of assets in part combined with a continuation of the tax attributes of the acquired entity. Neither prior law nor the Act's revision of the treatment of partial liquidations restrict a corporate purchaser from achieving such selectivity by purchasing assets directly from a corporation while concurrently purchasing the corporation's stock. Selectivity could also be achieved if an acquired corporation, prior to the acquisition, dispersed its assets in tax-free transactions among several corporations which could be separately purchased. The corporate purchaser then through selective qualifying liquidations could obtain asset purchase treatment for one or more acquired corporations while preserving the tax attributes of one or more other corporations.

Reasons for Change

While section 334(b)(2) did not permit selectivity within the context of a single corporation in that the transaction was treated as wholly an asset purchase or wholly a stock purchase, inconsistency was inherent in permitting a continuation of the acquired corporation's tax attributes for up to 5 years after a stock purchase while also treating the transaction as though assets had been purchased.

If consolidated returns were filed by the acquiring corporation, the tax attributes of the acquired corporation (including carryovers, subject to certain limitations in the Code and the consolidated return regulations) were reflected on such returns for the period prior to its complete liquidation. Recapture income triggered by liquidating distributions could be offset by losses of other members of the consolidated group, a result not available when assets are directly purchased.

Whether or not a consolidated return was filed, the extended period that could elapse between stock purchase and liquidation required complex adjustments for earnings or deficits of the acquired corporation during the intervening period as well as for sales of assets and other items during such period in order to properly allocate the cost of the stock to the assets upon their ultimate distribution. Existing case law permitted a stepped-up basis for assets distributed in liquidation that in some cases exceeded the cost basis that would be applicable if the assets were purchased directly by the controlling corporation. See, *R. M. Smith, Inc.*, 69 TC 317 (1977).

Prior law also provided unwarranted tax motivations for structuring a corporate acquisition as in part a purchase of assets and in part a purchase of stock or as a purchase of several corporations historically operated as a unit in order to preserve selectivity of tax treatment. These motivations included the ability to achieve a stepped-up basis for some assets while avoiding recapture tax and other unfavorable tax attributes with respect to other assets.

Explanation of Provisions

General treatment of stock purchase as asset purchase

The Act repeals the provision of prior law (sec. 334(b)(2)) that treated a purchase and liquidation of a subsidiary as an asset purchase. The amendments made by the Act were also intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine. Instead, an acquiring corporation, within 75 days after a qualified stock purchase, except as regulations may provide for a later election, may elect to treat an acquired subsidiary (target corporation) as if it sold all its assets pursuant to a plan of complete liquidation at the close of the stock acquisition date. The target corporation will be treated as a new corporation that purchased the assets on the day following such date. Gain or loss will not be recognized to the target corporation, except for gain or loss attributable to stock held by minority shareholders as described below, to the same extent gain or loss is not recognized (sec. 337) when a corporation sells all its assets in the course of a complete liquidation. This provision was intended to provide nonrecognition of gain or loss to the same extent that gain or loss would not be recognized under section 336 if there were an actual liquidation of the target corporation on the acquisition date to which prior law section 334(b)(2) applied.[1]

If, because of the application of other provisions of the Internal Revenue Code, the rules of section 337 providing for nonrecognition of gain or loss on the disposition of assets are made inapplicable, gain or loss is recognized under section 338. For example, section 337 does not apply to a sale or exchange of a United States real property interest by a foreign corporation (sec. 897(d)(2)). Thus, if the target corporation is a foreign corporation holding an interest in U.S. real property, gain or loss allocable to such interest is recognized if the acquiring corporation makes an election to which section 338(a) applies.

---

[1] To the extent that Internal Revenue Service rulings providing that gain or income is not recognized by a liquidating insurance company with respect to its insurance reserves in a section 334(b)(2) liquidation constitute a proper interpretation of prior law, gain or income is not recognized to the same extent upon an election to which new section 338 applies if the target corporation is an insurance company (see letter rulings 8112052 and 8150040).

It was intended that section 337(c) will not prevent the application of section 337 to a deemed sale and purchase of assets of a target corporation pursuant to section 338 even if the target corporation is a collapsible corporation (as defined in section 341(b)). Section 338 does not apply to the treatment of shareholders who sell target corporation stock; accordingly, any gain realized by the selling shareholders would be subject to recharacterization under section 341(a) if the target corporation was a collapsible corporation.

A qualified stock purchase occurs if 80 percent or more of the voting power and 80 percent of the total number of shares of other classes of stock (except nonvoting, preferred stock) is acquired by purchase during a 12-month period (the acquisition period). The acquisition date is the date within such acquisition period on which the 80-percent purchase requirement (the qualified stock purchase) is satisfied. Generally, the 80-percent purchase requirement may be satisfied through the combination of stock purchases and redemptions. However, it is expected that the regulations will provide rules to prevent selective asset distributions.

The election is to be made in the manner prescribed by regulations and, once made, will be irrevocable.

Treatment of target corporation as new corporation

The assets of the target corporation will be treated as sold (and purchased) for an amount equal to the grossed up basis of the acquiring corporation in the stock of the target corporation on the acquisition date. The amount is to be adjusted under regulations for liabilities of the target corporation and other relevant items. It was anticipated that recapture tax liability of the target corporation attributable to the deemed sale of its assets is an item which may result in an adjustment under the regulations.

Under the gross-up formula, if the acquiring corporation owns less than 100 percent by value of the target corporation's stock on the acquisition date, the deemed purchase price is grossed up to equal 100-percent ownership by the acquiring corporation. It was not intended that minority shareholders in the target corporation be treated as having exchanged their shares for stock in the new corporation. However, nonrecognition of gain or loss to the target corporation is limited, unless the target corporation is liquidated within one year after the acquisition date, to the highest actual percentage by value of target corporation stock held by the acquiring corporation during the one-year period beginning on the acquisition date.

If, in connection with a qualified stock purchase with respect to which an election is made, the target corporation makes a distribution in complete redemption of all the stock of a shareholder (other than the acquiring corporation), section 336 of the Code will apply to the distribution as if it were made in a complete liquidation. This will preclude gain from being recognized to the target corporation under the provisions relating to stock redemptions by a continuing corporation.

The Act provides that the deemed sale (and purchase) of all its assets by the target corporation applies for purposes of subtitle A of the Internal Revenue Code and is deemed to occur at the close of the acquisition date in a single transaction. Under these rules, the provisions of subtitle F of the Code relating to assessment, collection, refunds, statutes of limitations, and other procedural matters apply without regard to the status of the target corporation as a new corporation. The target corporation thus remains liable for any tax liabilities incurred by it for any period prior to the election. The target corporation is required to file an income tax return for its taxable year ending as of the close of the acquisition date.

In some cases, recapture items may be includible in income for a period during which the target corporation is included in a consolidated return of the acquiring corporation. Where, for example, there is an adjustment to the purchase price for its stock based on post-acquisition date earnings of the target corporation, there may be additional amounts of recapture income. Such additional income is to be separately accounted for and may not be absorbed by losses or deductions of other members of the acquiring corporation's affiliated group.

Deemed sale where target corporation included in consolidated return

Under the Act, if a qualified stock purchase caused the target corporation to cease to be a member of a consolidated return group, it was unclear whether the deemed sale of assets pursuant to a section 338 election was includible in the selling corporation's consolidated return or in a separate return of the target corporation. In order to eliminate uncertainty, the Technical Corrections Act of 1982 (TCA) amended section 338 to provide, as a general rule and except as regulations may otherwise provide, that the target corporation will not be treated as a member of an affiliated group with respect to the deemed sale. It is contemplated that regulations may provide for consolidation of the deemed sales of several target corporations disposed of from the same affiliated group.

As an exception to the general rule, an election under regulations is to be provided pursuant to which the transaction will be treated as a sale by the target corporation of all its assets in a single transaction in which gain or loss is recognized to the same extent as in an actual sale and the target corporation will be a member of the selling corporation's consolidated return group with respect to the sale. Gain or loss to any member of such selling group from the sale or exchange of target corporation stock is not to be recognized to the extent the regulations so provide. Except as expressly provided by the regulation, this election may not be made for a transaction entered into before such regulations are promulgated.

Because of the uncertain status of transactions prior to enactment of the TCA, with respect to a qualified stock purchase any portion of which is pursuant to a binding contract entered into on or after the date of enactment of the Act and on or before the date of enactment of the TCA, the rules providing for separate return treatment of the deemed sale of assets and the elective exception thereto will not apply if the purchasing corporation establishes by clear and convincing evidence that the contract was negotiated with the contemplation that the target corporation would be treated as a member of the selling corporation's consolidated return group with respect to the deemed asset sale.

The TCA also extends until February 28, 1983, the period of time within which any election under section 338 may be made and authorizes any election previously made to be revoked on or before such date.

Definition of purchase

The term "purchase" is defined as it was under prior law (sec. 334(b)(3)) to exclude acquisitions of stock with a carryover basis or from a decedent, acquisitions in an exchange to which section 351 applies, and acquisitions from a person whose ownership is attributed to the acquiring person under section 318(a). Attribution under section 318(a)(4) relating to options will be disregarded for this purpose. However, if, as a result of a stock purchase, the purchasing corporation is treated under section 318(a) as owning stock in a third corporation, the purchasing corporation will be treated as having purchased stock in such third corporation but not until the first day on which ownership of such stock is considered as owned by the purchasing corporation under section 318(a). This rule may be illustrated by the following example:

Assume a target corporation and a third corporation each have only one class of stock outstanding and that the target corporation owns 50 percent of the stock of the third corporation. The purchasing corporation purchases 20 percent of the target corporation on each of five separate dates, January 1, April 1, July 1, October 1, and December 31, 1983. Under section 318(a), no portion of the stock of the third corporation is constructively owned by the purchasing corporation until July 1, 1983, the date on which its ownership of the target corporation first exceeds 50 percent (sec. 318(a)(2)(C). On that date, the purchasing corporation is treated as purchasing 30 percent (60 percent of 50 percent) of the third corporation. By virtue of the remaining purchases of the target corporation stock, the purchasing corporation will be treated as having purchased 50 percent of the third corporation's stock by December 31, 1983. If, by June 30, 1984 (the end of the 12-month acquisition period applicable to the third corporation), either the purchasing corporation or the target corporation purchases an additional 30 percent of the third corporation, an election, if made for the target corporation, would also apply to the third corporation.

In the above example, the amount for which the assets of the third corporation are treated as sold (and purchased) is determined by reference to the portion of the price paid for the target corporation's stock allocable to the 50-percent interest in the third corporation's stock owned by the target corporation plus any amount paid

BEST COPY AVAILABLE

to purchase an additional 30 percent of such stock after December 31, 1983, and within the remaining portion of the acquisition period applicable to the third corporation. If ownership of the third corporation is less than 100 percent on the acquisition date, the basis so determined is grossed up pursuant to section 338(b)(2).

A purchase of over 80 percent but less than 100 percent of the stock of a target corporation which in turn owns 80 percent of the stock of a third corporation is not a qualified stock purchase with respect to the third corporation because the purchasing corporation has not acquired by purchase the requisite 80 percent of the third corporation's stock. This is so, even though the purchasing corporation, the target corporation, and the third corporation constitute an affiliated group as defined in section 1504(a).

Consistency requirement

The rules require consistency where the purchasing corporation makes qualified stock purchases of two or more corporations that are members of the same affiliated group. For this purpose, purchases by a member of the purchasing corporation's affiliated group, except as regulations provide otherwise, are treated as purchases by the purchasing corporation.[2] The consistency requirement applies as well to a combination of a direct asset acquisition and qualified stock purchase.

The consistency requirement applies with respect to purchases over a defined "consistency period" determined by reference to the acquisition date applicable to the target corporation. The "consistency period" is the one-year period preceding the target corporation acquisition period plus the portion of the acquisition period up to and including the acquisition date, and the one-year period following the acquisition date. Thus, if all the target corporation's stock is purchased on the same day by the purchasing corporation, the one-year period immediately preceding and the one-year period immediately following such day are included in the consistency period. If, within such period, there is a direct purchase of assets from the target corporation or a target affiliate by the purchasing corporation, the rules require that the acquisition of the target corporation be treated as an asset purchase.

The consistency period may be expanded in appropriate cases by the Secretary where there is in effect a plan to make several qualified stock purchases or any such purchase and asset acquisition with respect to a target corporation and its target affiliates.

The consistency requirement is applied to an affiliated group with reference to a target corporation and any "target affiliate." A corporation is defined as a "target affiliate" of the target corporation if each was, at any time during that portion of the consistency period ending on the acquisition date of the target corporation, a member of an affiliated group that had the same common parent. An affiliated group has the same meaning given to such term by section 1504(a) (without regard to the exceptions in sec. 1504(b)). This definition also applies in determining whether a purchase is made by a member of the same affiliated group as the purchasing corporation.

---

[2] Transfers of target corporation stock within the purchasing corporation's affiliated group will not disqualify a section 338 election (cf. *Chrome Plate Inc.* v *U.S.*, 614 F.2d 990 (5th Cir. 1980)).

An acquisition of assets from the target corporation or a target affiliate during the consistency period applicable to the target corporation will require the qualified stock purchase of the target corporation to be treated as a purchase of assets. In applying these rules, stock in a target affiliate is not to be treated as an asset of any other target affiliate or of the target corporation.

In applying these rules, acquisitions of assets pursuant to sales by the target corporation or a target affiliate in the ordinary course of its trade or business and acquisitions in which the basis of assets is carried over will not cause the consistency requirement to apply. The sale by a target corporation will be considered as a sale in the ordinary course of business for this purpose even though it is not customary in the course of the selling corporation's business provided it is a transaction that is a normal incident to the conduct of a trade or business, such as a sale of used machinery that was employed in the seller's trade or business.

Where there are, within a consistency period, only qualified stock purchases of the target corporation and one or more target affiliates by the purchasing corporation, an election with respect to the first purchase will apply to the later purchases. A failure to make the election for the first purchase will preclude any election for later purchases.

To prevent avoidance of the consistency requirements, the Act authorizes the Secretary to treat stock acquisitions which are pursuant to a plan and which satisfy the 80-percent requirement to be treated as qualified stock purchases even though they are not otherwise so defined. For example, an acquiring corporation may acquire 79 percent of the stock of a target corporation and, within a year, purchase assets from such corporation or a target affiliate planning to purchase the remaining target corporation stock more than one year after the original stock purchase. The Secretary may under these circumstances treat the purchase of the target corporation's stock as a deemed sale of its assets by the target corporation. The Act also authorizes such regulations as may be necessary to ensure that the requirements of consistency of treatment of stock and asset purchases with respect to a target corporation and its target affiliates are not circumvented through the use of other provisions of the law or regulations, including the consolidated return regulations.

Except as provided in regulations and subject to such conditions as may be provided in regulations, the term 'target affiliate' does not include a foreign corporation or a DISC or a corporation to which section 934(b) or section 936 applies, and section 338 does not apply to stock held by a target affiliate in a foreign corporation or a domestic corporation which is a DISC or which is described in section 1248(e).

The acquisition of assets before September 1, 1982, and, to the extent provided under regulations, assets located outside the United States will not result in a deemed section 338 election with respect to a target corporation.

The Act provides regulatory authority pursuant to which the Secretary may determine that the deemed election will not apply as the result of a *de minimis* acquisition of assets and may also preclude the application of the deemed election rule if it is determined that the taxpayer has acquired assets in order to avoid the 75-day limit on the period after the acquisition date within which the election must be made.

The application of the consistency requirements is illustrated in the following examples. In these examples, all assets are located in the United States, and all corporations are domestic corporations which are not DISCs or corporations described in sections 934(b), 936, or 1248(e).

Example 1

The acquiring corporation makes a qualified stock purchase of T's stock and within a one-year period purchases assets from T or a target affiliate of T. The acquiring corporation is deemed to have made an election with respect to T as of the acquisition date applicable to T.

Example 2

The acquiring corporation makes a qualified stock purchase of T's stock and makes the election within 75 days of the acquisition date. The acquiring corporation is treated as having acquired by purchase the stock of any other corporation owned by T actually or constructively which is attributed to the acquiring corporation under section 318(a) (other than sec. 318(a)(4)). To the extent that such treatment results in qualified stock purchases by the acquiring corporation of other corporations actually or constructively owned by T, the election with respect to T applies to all such corporations. Each such corporation will be treated as having sold (and as having purchased as a "new" corporation) its assets on the acquisition date with respect to T. Gain or loss will not be recognized to the extent gain or loss is not recognized under section 337. The deemed sale price of the assets will be determined by reference to the grossed-up amount allocated to the stock of each selling corporation as a result of the qualified stock purchase and election with respect to T.

Example 3

P, an acquiring corporation, makes a qualified stock purchase of all the stock of corporation T on February 1, 1983. No election is made. On December 1, 1983, P makes a qualified stock purchase of all the stock of corporation U, a target affiliate of corporation T. No election may be made with respect to corporation U.

Effective Date

The amendments made by sec. 224 of the Act apply to qualified stock purchases of a target corporation where the acquisition date occurs after August 31, 1982. However, in any case where the acquisition date occured after August 31, 1980, and before September 1, 1982, and the target corporation was not liquidated before September 1, 1982, the purchasing corporation may elect to have section 338 apply. Under section 224(d)(2) of the Act, this election was required to be made by November 15, 1982. Further, under the

Act, the deemed sale of assets was treated as having taken place on the acquisition date whether the qualified stock purchase took place before or after the general effective date. Because it was unclear whether the deemed sale of a target corporation's assets was includible in the selling corporation's consolidated return prior to enactment of the TCA, there was uncertainty under the Act as to whether a transitional period section 338 election (i.e., an election where the acquisition date was before September 1, 1982) by a purchasing corporation resulted in additional tax liability on the consolidated return of a selling corporation with respect to a sale of stock occurring prior to the general effective date of the Act.

As modified by the TCA, the deemed asset sale in the case of a section 338 election with respect to a transaction when the acquisition date was before September 1, 1982, is to be a date selected by the taxpayer which occurs after the later of June 30, 1982, or the acquisition date, and on or before the date the election is made. This modification clarifies that the deemed sale of assets will take place after the target corporation is no longer a member of the selling corporation's consolidated return group and any tax liability with respect to the deemed sale is not includible in a consolidated return of the selling corporation.

Under the modification, adjustments must be made for distributions and other items attributable to operations of the target corporation between the date of the stock purchase and the date of the deemed sale of assets. These adjustments are comparable to those that were required to be made when a target corporation was liquidated under prior law section 334(b)(2). Also, the rules requiring consistency of treatment when several acquisitions are made from the same affiliated group do not apply under the modification. It is expected that, as for purposes of section 334(b)(2) of prior law, the Internal Revenue Service will permit the aggregation of purchases of a target corporation's stock by members of an affiliated group filing a consolidated return in determining whether a qualified stock purchase has taken place for purposes of the transitional period election and transfers of such stock within the purchasing corporation's affiliated group will not disqualify the election.

Under the TCA, the extension to February 28, 1983, of the period within which a section 338 election may be made or revoked applies with respect to transitional period elections. If such an election was made on or before November 15, 1982, it may be revoked for the purpose of making a new election, in order to select a different date as the deemed assets sale date.

At the election of the purchasing corporation, section 338 will not apply to any acquisition made pursuant to a contract binding on July 22, 1982, to acquire control (within the meaning of sec. 368(c)) of any financial institution where completion of the acquisition is subject to approval by one or more regulatory authorities and a plan of complete liquidation of one or more corporations acquired pursuant to such contract is adopted within 90 days after the date of final approval of the last such regulatory authority granting final approval. For purposes of these rules, a financial institution includes a bank holding company within the meaning of section 2(a) of the Bank Holding Company Act of 1956. Additionally, final approval includes, when applicable, expiration of the period of review of the acquisition by the Department of Justice.

d. Reorganizations constituting changes in form (sec. 225 of the Act and sec. 368(a)(1)(F) of the Code)*

Prior Law

A reorganization includes "a mere change in identity, form, or place of organization" (an F reorganization). Generally, applicable rules require a transferor corporation's taxable year to be closed on the date of a reorganization transfer and preclude a post-reorganization loss from being carried back to a taxable year of the transferor. However, F reorganizations were excluded from these limitations under prior law in recognition of the intended scope of such reorganizations as embracing only formal changes in a single operating corporation. Court decisions have permitted certain fusions of several operating companies to qualify as F reorganizations as long as there is sufficient identify of proprietary interest and there is uninterrupted business continuity.

Reasons for change

The exception for F reorganizations from the restrictions on closing the taxable year of a transferor and limiting carrybacks are not appropriate to mergers of several active business corporations.

Explanation of Provision

The Act limits the F reorganization definition to a change in identity, form, or place of organization of a single operating corporation.

This limitation does not preclude the use of more than one entity to consummate the transaction provided only one operating company is involved. The reincorporation of an operating company in a different State, for example, is an F reorganization that requires that more than one corporation be involved.

Effective Date

The amendment applies to transactions occurring after August 31, 1982. Present law continues to apply to plans of reorganization adopted before August 31, 1982, provided the transaction is completed by December 31, 1982.

e. Use of holding companies to bail out earnings (sec. 226 of the Act and secs. 304, 306 and 351 of the Code)[1]

Prior Law

Shareholders who have their stock redeemed in a corporate distribution not in partial or complete liquidation are entitled to sale or exchange treatment rather than dividend treatment generally only if the transaction results in a termination or substantial reduction in the proportionate interests of the redeeming shareholders. Where the same shareholder or a group commonly controls two or more corporations, they may attempt to avoid the dividend consequences that would result from a pro rata redemption of stock by selling the stock in one controlled corporation to another. Section 304 deals with this effort to avoid dividend treatment by generally testing the tax consequences of the transaction as if the shareholders had their stock redeemed by the corporation whose stock is sold.

---

* For legislative background of the provision, see H. Rep. No. 97-760 (August 17, 1982), pp. 540, 541 (Joint Explanatory Statement of the Committee of Conference).

[1] For legislative background of the provisions, see H. Rep. No. 97-760 (August 17, 1982), pp. 541-543. (Joint Explanatory Statement of the Committee of Conference).

Shareholders have attempted to avoid the prior law rules by borrowing funds secured by the stock of a corporation with earnings and profits and contributing the stock to a newly formed holding company in exchange for the holding company's stock plus its assumption of the liability for the borrowed funds. Taxpayers argued that the transaction complied with the rules governing tax-free incorporation of property. These rules overlap with those requiring stock sales to a commonly controlled corporation to be tested as stock redemptions. The courts were divided as to which provision controlled under prior law. It was also unclear whether section 304 applied where the holding company was a newly formed corporation. Even if the redemption rule applied and dividend treatment resulted, dividend consequences would be determined by reference to the earnings of the purchasing corporation. If it was a newly formed holding company, it would have no earnings (a pre-existing corporation without earnings could also be used).

Another device to distribute earnings without dividend consequences was to cause a corporation to issue preferred stock as a nontaxable stock dividend to its shareholders. A sale of the preferred stock at capital gain rates would not dilute the interests of the selling shareholders in future corporate growth while they would receive an amount representing corporate earnings. Preferred stock issued under these circumstances (described as section 306 stock) is tainted so that its subsequent sale or redemption results in ordinary income to the shareholder. This provision under prior law did not taint stock of a newly formed corporation issued in a tax-free transaction in exchange for stock in a corporation with earnings and profits. Thus, creation of a holding company issuing both common and preferred stock offered the same bail-out opportunity as a preferred stock dividend but did not result in tainted section 306 stock.

Reasons for Change

The rules of section 304 and 306 were intended to produce dividend consequences for transactions that were substantially similar to dividends. Congress believed that to insure the effectiveness of such rules, they should be extended to reach economically equivalent transactions involving the use of holding companies.

Explanation of Provision

The Act extends the anti-bailout rules of sections 304 and 306 to the use of corporations, including holding companies, formed or availed of to avoid such rules. Such rules are made applicable to a transaction that otherwise qualifies as a tax-free incorporation under section 351.

Section 351 generally will not apply to transactions described in section 304. Thus, section 351, if otherwise applicable, will generally apply only to the extent such transaction consists of an exchange of stock for stock in the acquiring corporation. However, section 304 will not apply to debt incurred to acquire the stock of an operating company and assumed by a controlled corporation acquiring the stock since assumption of such debt is an alternative to a debt-financed direct acquisition by the acquiring company. This exception for acquisition indebtedness applies to an extension, renewal, or refinancing of such indebtedness. The provisions of section 357 (other than sec. 357(b)) and section 358 apply to such acquisition indebtedness provided they would be applicable to such transaction without regard to section 304. In applying these rules, indebtedness includes debt to which the stock is subject as well as debt assumed by the acquiring company.

Under the Act, section 306 is made applicable to preferred stock acquired in a section 351 exchange if, had money in lieu of stock been received, its receipt would have been a dividend to any extent. Thus, if the receipt of cash by the shareholder rather than stock would have caused section 304 as amended by the Act, rather than section 351, to apply to such receipt, some or all of the amount received might have been treated as a dividend. In such a case, the preferred stock acquired in the exchange will be section 306 stock.

To the extent of any amount distributed (including any liability assumed or to which the stock is subject) in an exchange for stock to which section 304(a)(1) applies, the earnings and profits of the issuing corporation, to the extent thereof, will be deemed to be distributed to the acquiring company. This rule also applies in determining whether preferred stock acquired in a section 351 exchange is section 306 stock. For this purpose, the property is deemed distributed by the issuing to the acquiring corporation and thereafter distributed to the exchanging shareholders. The deemed distribution is solely for the purpose of determining the extent to which the amount distributed is treated as a dividend to such shareholders and does not, for example, constitute a distribution of personal holding company income to the acquiring corporation.

In determining whether corporations are commonly controlled for purposes of section 304, all shareholders transferring stock to a holding company are counted even though some of them do not receive property other than stock.

An exception applies to the receipt of securities in a bank holding company by certain minority shareholders. Under this rule, the transfer of stock constituting control of a bank to a bank holding company in connection with the formation of such company (unless such company is formed before 1985) must be made within 2 years after control of such bank was acquired. Both acquisition of control of the bank and the transfer of its stock constituting control to the bank holding company must be pursuant to a plan. Further, distributions of property (as described in sec. 304(a)) incident to the formation of such bank holding company may be made only to shareholders who, in the aggregate, do not have stock constituting control of such company. For this purpose, liability incurred in acquiring control of the bank and assumed by the bank holding company (or to which the bank stock acquired by the bank holding company is subject) is not property described in section 304(a).

If the above conditions are satisfied, section 304(a) will not apply to securities received, incident to the formation of the bank holding company, by any shareholder who owns less than 10 percent in value of the stock of such company.

Control, for purposes of applying this exception, means control as defined in section 304(c)(1) and ownership is to be determined under the rules in section 304(c)(3). A bank holding company is a bank holding company within the meaning of the Bank Holding Company Act.

Effective Date

The amendments made by the Act apply to transfers occurring after August 31, 1982, in taxable years ending after such date. However, if an application was filed with the Federal Reserve Board before August 16, 1982, to form a bank holding company, the amendments will not apply to transfers by a bank holding company formed pursuant to approval of such application if such transfers are made before January 1, 1983, or (if later) within 90 days after the last final required regulatory approval of such formation.

f. Application of attribution rules (sec. 227 of the Act and secs. 306 and 356(a)(2) of the Code)*

Prior law

To determine whether a shareholder is entitled to sale or exchange treatment on a stock redemption, stock held by related parties is attributed to the shareholder in determining whether the shareholder's interest in the corporation was terminated or significantly reduced. Under prior law, the attribution rules did not apply to some transactions that were economically equivalent to straight stock redemptions and that offered an equivalent opportunity to distribute earnings. For example, a shareholder could exchange all of his common stock in a corporation for preferred stock. Such an exchange resulted in tainted, section 306 stock only if, had cash been distributed in lieu of preferred stock, there would have been a dividend. Unless stock held by another family member or controlled entity was attributed to the shareholder, cash in lieu of preferred stock would have terminated the shareholder's interst and not result in a dividend. Also, a shareholder exchanging stock in a reorganization for property other than stock or securities might have dividend consequences if the transaction had the effect of the distribution of a dividend. For this purpose, attribution rules did not apply.

---

*For legislative background of the provision, see H. Rep. No. 97-760 (August 17, 1982), pp. 544 (Joint Explanatory Statement of the Committee of Conference).

Reasons for Change

Attribution rules applicable in determining whether straight stock redemptions result in dividend consequences to the shareholder are equally relevant to other transactions that offer a comparable opportunity to bail out earnings and the failure of prior law to apply attribution rules to such transactions resulted in unwarranted avoidance of dividend consequences.

Explanation of Provision

The Act extends the ownership attribution rules to a determination of whether, for section 306, the effect of the receipt of preferred stock pursuant to a reorganization or a transaction described in section 355 or section 351 is substantially the same as a dividend and in determining whether the receipt of property in a reorganization has the effect of a dividend. Attribution between shareholders and corporations is to be applied without regard to the 50-percent limit in section 318(a)(3)(C) and 318(a)(2)(C) in applying such rules to the receipt of preferred stock in a section 351 exchange.

Effective Date

The application of constructive ownership rules to section 306 determinations applies to stock received after August 31, 1982, in taxable years ending after such date. Application of such rules to the determination of whether the receipt of property pursuant to a reorganization has the effect of a dividend applies to distributions after August 31, 1982, in taxable years ending after such date.

g. Waiver of family attribution rules (sec. 228 of the Act and sec. 302(c)(2) of the Code)*

Prior Law

In determining whether a shareholder has completely terminated his interest in a corporation on a stock redemption so as to achieve sale or exchange treatment, the shareholder may waive attribution of ownership from other family members. The waiving shareholder in general may hold no interest in the corporation (except as a creditor), may not acquire any interest for a 10-year period, and must agree to notify the Internal Revenue Service of any such acquisition. The statute of limitations for the year of redemption remains open in the event of such an acquisition.

Stock may be attributed from one member of a family to another by family attribution and reattributed to an entity such as an estate or trust in which the constructive owner has a beneficial interest. The Internal Revenue Service took the position that only an individual may waive family attribution. Several decided cases held that a trust or an estate terminating its interest by a stock redemption can waive family attribution from a family member to the beneficiary. These cases did not preclude the beneficiary from ac-

---

*For legislative background of the provision, see H. Rep. No. 97-760 (August 17, 1982), pp. 544-546 (Joint Explanatory Statement of the Committee of Conference).

BEST COPY AVAILABLE

quiring an interest in the corporation, did not require an agreement from the beneficiary, and did not reopen the statute of limitations in the event of an acquisition by the beneficiary. One case also held that an entity may waive attribution from a beneficiary to the entity.

Reasons for Change

In determining whether a stock redemption terminates the interest of an individual in a corporation, analogous rules should apply to stock owned indirectly by such individual through an entity and to stock owned directly. Judicial decisions construing prior law did not produce analogous results in these cases because the safeguards precluding the shareholder from reacquiring an interest and other anti-avoidance rules did not apply to the individual beneficiary when the stock redeemed was held by an entity.

Explanation of Provision

The Act permits an entity to waive the family attirbution rules if those through whom ownership is attributed to the entity join in the waiver. Thus, a trust and its beneficiaries may waive family attribution to the beneficiaries if, after the redemption, neither the trust nor the beneficiaries hold an interest in the corporation, do not acquire such an interest within the 10-year period, and join in the agreement to notify the IRS of any acquisition. The entity and beneficiaries are jointly and severally liable in the event of an acquisition by any of them within the 10-year period and the statute of limitations remains open to assess any deficiency. The tax increase is a deficiency in the entity's tax but may be asserted as a deficiency against any beneficiary liable under the rules. Congress intended that the tax will be collected from a beneficiary only when it cannot be assessed against or collected from the entity, such as when the entity no longer exists or has insufficient funds. Further, it was intended that the tax will be assessed and collected from the beneficiary whose acquisition causes the deficiency before it is asserted against any other beneficiary.

Under the Act, only family attribution under section 318(a)(1) may be waived by an entity and its beneficiaries. The waiver rules are not extended to waivers of attribution to and from entities and their beneficiaries (secs. 318(a)(2) and 318(a)(3)). The Act thus is intended to overrule *Rickey* v. *United States,* 592 F.2d 1251 (5th Cir. 1979). Congress intended that the Act should not be construed to provide any inference as to whether the *Rickey* decision adopts a proper construction of prior law. Nor was any inference intended as to whether the other cases extending the waiver rules for family attribution to entities adopt a proper construction of prior law.

Certain anti-avoidance rules applicable where the redeemed stock was acquired by the distributee from a related party or a related party at the time of the redemption owns stock acquired from the distributee are extended to the entity and affected beneficiaries.

Effective Date

These amendments apply with respect to distributions after August 31, 1982, in taxable years ending after such date.

h. Revenue effect of merger and acquisition changes

The provisions in the Act relating to mergers and acquisitions are expected to increase fiscal year budget receipts by $427 million in 1983, $749 million in 1984, $959 million in 1985, $1,014 million in 1986, and $1,064 million in 1987.

10. Completed contract method of accounting (sec. 229 of the Act)*

Prior Law

Overview

Under both present and prior law, a taxpayer who enters into long-term contracts may elect to use one of four accounting methods to account for the income and expenses attributable to such contracts. Long-term contracts generally are building, installation, construction, or manufacturing contracts that are not completed by the end of the taxable year in which they were entered into. A manufacturing contract is not a long-term contract unless it involves the manufacture of either (1) unique items of a type not normally carried in the finished goods inventory of the taxpayer or (2) items that normally require more than 12 months to complete.

The four methods used to account for long-term contracts are the cash method, the accrual method, the percentage of completion method, and the completed contract method. The cash and accrual methods are methods applicable to all types of income of taxpayers generally. The percentage of completion method and the completed contract method apply only to long-term contracts.

Cash method

Under the cash method, income is reported for the year in which it is actually or constructively received. Deductions generally are taken for the year in which actually paid. Therefore, a taxpayer who uses the cash method to account for income and expenses for long-term contracts includes payments in income when received (either before or after completion of the contract) and takes deductions for expenses when actually paid.

Accrual method

Under the accrual method, income is generally reported when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy, regardless of when it is received. Where the taxpayer accrues income on shipment, delivery, or acceptance under the accrual method, advance payments under a long-term contract are includible at the time of shipment, delivery, or acceptance.

If an accrual basis taxpayer does not use inventories in connection with a long-term contract, deductions generally are allowed for the year in which all events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy. If the taxpayer uses inventories, costs allocable to inventory are accumulated until the inventory is shipped, delivered, or accepted.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 231; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 198-203; and H. Rept. No. 97-760 (August 17, 1982), pp. 547-550 (Joint Explanatory Statement of the Committee of Conference).

Percentage of completion method

Under the percentage of completion method (which is used only for long-term contracts), income is recognized according to the percentage of the contract that is completed during each taxable year. The computation of how much of the contract is completed during a taxable year may be made by comparing (1) the costs incurred during the year to the total estimated costs of the contract or (2) the physical work performed on the contract during the year to the total estimated work to be performed. Expenses of the long-term contract are deductible for the year in which they are incurred.

Completed contract method

Overview

Under the completed contract method (which is used only for long-term contracts), income and costs from the contract generally are reported for the year in which the contract is completed.

Completion of the contract

The Treasury regulations existing prior to the changes required by the Act (§ 1.451-3) provide that a contract will not be considered completed until final completion and acceptance have occurred. Nevertheless, a taxpayer may not delay completion of a contract for the principal purpose of deferring Federal income tax. For a subcontractor who completes his work on a long-term contract before completion of the entire contract, "final completion and acceptance" of the contract is deemed to occur for the subcontractor when the subcontractor's work has been completed and has been accepted by the party with whom he has contracted. In cases where there is a contract dispute after the taxpayer has tendered the subject matter of the long-term contract to the purchaser, special rules are provided to determine when income and costs are to be taken into account.

Severing and aggregating contracts

The Treasury regulations existing prior to the changes required by the Act also provide that it may be necessary to treat one agreement as several contracts or several agreements as one contract in order to reflect clearly the income of the taxpayer. Whether one agreement is severed or several agreements are aggregated depends on all the facts and circumstances. Generally, one agreement will not be treated as several contracts unless either (1) the agreement contemplates separate delivery or separate acceptance of portions of the subject matter of the contract or (2) there is no business purpose for entering into one agreement rather than several. Generally, several agreements will not be treated as one contract unless either (1) the several agreements would be treated as a single agreement under customary commercial practice in the taxpayer's trade or business or (2) there is no business purpose for entering into several agreements rather than one. The fact that one agreement would not have been made on the agreed-upon terms if the same parties had not made a second agreement is evidence that the two agreements should be treated as a single contract.

Deduction of expenses

Under the completed contract method, expenses allocable to the contract (commonly referred to as "contract costs") are deductible for the year in which the contract is completed. Expenses that are not allocated to the contract (commonly referred to as "period costs") are deductible for the year in which they are paid or incurred.

Under the regulations existing prior to the changes required by the Act, contract costs include all direct expenses and indirect expenses that are incident and necessary to the performance of the contract, with the following exceptions (which are currently deductible as period costs):

(a) Marketing and selling expenses, including bidding expenses;

(b) Advertising expenses;

(c) Other distribution expenses;

(d) General and administrative expenses which benefit the taxpayer's business as a whole;

(e) Interest;

(f) Research and development expenses;

(g) Losses, under section 165 and the regulations thereunder;

(h) Percentage depletion in excess of cost depletion;

(i) Depreciation on idle equipment and, for other equipment, tax depreciation in excess of book depreciation;

(j) Income taxes;

(k) Pension and profit-sharing contributions and other employee benefits;

(l) Costs attributable to strikes, rework, scrap, and spoilage; and

(m) Officer compensation which benefits the taxpayer's activities as a whole.

Reasons for Change

Congress believed that the prior rules relating to the completed contract method of accounting needed to be changed because the income of some taxpayers using that method of accounting was not being clearly reflected. The method had not resulted in a clear reflection of income due, in part, to deferral of the completion of the contract for tax purposes by reason of contractual obligations that were merely incidental to the taxpayer's obligation to build, construct, install, or manufacture the subject matter of the contract. Also, completion of contracts had been deferred for tax purposes by treating certain agreements as a single contract for several units rather than several contracts for single units, even though each unit was delivered or accepted separately and had been separately and independently priced. Congress believed, therefore, that Treasury should amend its regulations to prevent this inappropriate deferral of income.

In addition, clear reflection of income under the method had not occurred in certain cases because many significant costs that were incident to and necessary for the performance of long-term contracts were treated as period costs and, therefore, were not matched with the income to which they related. This problem was of less concern in the case of contracts that were completed in a relatively short period of time, e.g., two years or less. Therefore, Congress believed that Treasury should amend its regulations to require, generally, that, in the case of contracts expected to take more than 24 months to complete, costs that directly benefit, or are incurred by reason of, such extended period long-term contracts should be allocated to such contracts. However, in the case of construction contracts, which Congress understood usually have less than a 36-month duration, Congress was concerned that many small businesses would be unduly burdened by a requirement to allocate more indirect costs to long-term contracts. Therefore, Congress believed it was appropriate that construction contracts that are expected to be completed within 36 months should not be subject to the new cost allocation rules. Also, in the case of small businesses with average annual gross receipts of no more than $25 million, Congress believed it was appropriate to exempt all construction contracts of such businesses from the new cost allocation rules.

Congress recognized that the new cost allocation rules would have a significant impact on certain taxpayers. Therefore, as a transition rule, Congress believed it was appropriate to phase in the new cost allocation rules over a 3-year period.

Explanation of Provision

The Act directs the Treasury to modify its regulations relating to the determination of when a contract is completed and when agreements should be severed or aggregated. The Treasury also is directed to modify its regulations relating to the use of the accrual method of accounting with respect to long-term contracts. Congress intended that these modified rules would prevent unreasonable deferral of recognition of income and will apply to all taxpayers who use either the completed contract method of accounting or the accrual method of accounting.

The Act also directs the Treasury to modify its regulations relating to the allocation of costs to long-term contracts.[1] Except as provided in the case of certain construction contracts, costs that are treated as period costs under present law will be allocated to long-term contracts if such costs either directly benefit, or are incurred by reason of, contracts that are not estimated to be completed within 24 months (hereafter referred to as "extended period long-term contracts"). These costs include the following:

(1) Bidding expenses on contracts awarded to the taxpayer;

(2) Distribution expenses, such as shipping costs;

(3) General and administrative expenses properly allocable to long-term contracts under regulations to be prescribed by the Secretary;

---

[1] In order to prevent avoidance of the new cost allocation rules, it was anticipated that Treasury may be required to amend both the regulations relating to the completed contract method and the regulations relating to the full absorption inventory costing method.

(4) Research and development expenses that either are directly attributable to particular long-term contracts existing when the expenses are incurred or are incurred under an agreement to perform research and development;

(5) Depreciation, capital cost recovery, and amortization for equipment and facilities currently being used in the performance of extended period long-term contracts, to the extent it exceeds depreciation reported by the taxpayer for financial accounting purposes;

(6) Pension and profit-sharing contributions representing current service costs and other employee benefits;

(7) Rework labor, scrap and spoilage; and

(8) Percentage depletion in excess of cost depletion.

Costs that would continue to be currently deductible include the following:

(1) Interest;

(2) Marketing, selling, and advertising expenses;

(3) Bidding expenses for contracts not awarded to the taxpayer;

(4) Research and development expenses neither directly attributable to particular long-term contracts existing when the expenses were incurred nor incurred under an agreement to perform such research and development;

(5) Losses under section 165 and the regulations thereunder;

(6) Depreciation, capital cost recovery, and amortization for idle equipment and facilities;

(7) Income taxes attributable to income received from long-term contracts;

(8) Pension and profit-sharing contributions representing past service costs;

(9) Costs attributable to strikes; and

(10) General and administrative expenses not allocable to long-term contracts under regulations to be prescribed by the Secretary.

With respect to general and administrative expenses, Congress intended that the Treasury issue regulations that require additional costs to be allocated to extended period long-term contracts, i.e., those costs that directly benefit, or are incurred by reason of, the performance of extended period long-term contracts. Costs may directly benefit extended period long-term contracts of the taxpayer even though the same type of costs also benefit other activities of the taxpayer. However, general or administrative expenses which would be incurred in the operation of the taxpayer's general management or policy guidance functions (such as financial officers' salaries) would continue to be deductible currently.

These new contract cost allocation rules do not apply in the case of construction contracts entered into in a taxable year if the taxpayer's average annual gross receipts from all businesses over the 3 preceding taxable years is $25 million or less. For purposes of this rule, all trades or businesses under common control are to be treated as one taxpayer. The determination of "common control" is to be made in a manner consistent with the principles of section 52. In order to prevent abuse of the gross receipts test, the Treasury is to prescribe any regulations necessary to deal with taxpayers who engage in construction contracts through partnerships, joint ventures, and corporations.

The new contract cost allocation rules also do not to apply to any other taxpayer in the case of a construction contract that is expected to be completed within 36 months. For purposes of these special rules, a "construction" contract is a contract for the building, construction, reconstruction, or rehabilitation of an improvement to real property or the installation of integral components of an improvement to real property. An improvement to real property includes buildings, roads, dams, and similar property. Thus, for example, a contract for the installation of elevators in an office building is a construction contract. A contract to build elevators, on the other hand, is not a construction contract.[2]

For purposes of determining the expected length of time required to complete a contract, a contract begins at the time it is estimated that any costs allocable to the contract (other than bidding expenses) will first be incurred. The new contract cost allocation rules are to be used to make this determination. The determination of the expected duration of the contract is to be made when the contract is entered into.

Effective Date

The provisions of the Act relating to contract cost allocation rules apply to costs incurred in taxable years beginning after December 31, 1982, with respect to contracts entered into after December 31, 1982. During a transition period, however, a percentage of the additional costs that are to be treated as contract costs under the revised rules may be deducted currently. The percentage of these costs that may be currently deducted is as follows:

For taxable years beginning in 1983, the currently deductible percentage is 66⅔;

For taxable years beginning in 1984, the currently deductible percentage is 33⅓; and

For taxable years beginning in 1985 and later years, the currently deductible percentage is 0.

No adjustment is to be made under section 481 by reason of a taxpayer's change in method of accounting for contract and period costs required by the Act. Such a change includes a change in method of accounting required or permitted under the $25 million gross receipts test for construction contracts.

The revised completion rules apply to taxable years ending after December 31, 1982. Contracts that would be treated as completed in an earlier taxable year solely by reason of the revised termination rule would be treated as completed in the first taxable year ending after December 31, 1982.

The revised severance and aggregation rules apply to taxable years ending after December 31, 1982. A contract that would have been completed in an earlier taxable year if it had been severed from a group of contracts under the revised rules will be considered completed when the first contract of the same group is completed after December 31, 1982.

---

[2] In the case of a contract for the manufacture and installation of an improvement to real property, the special cost allocation rules for construction contracts apply to only the costs related to the installation of the real property improvements. For purposes of determining whether such a contract is expected to be completed within 3 years, the time expected to complete both the manufacture and installation of the property will be taken into account.

Revenue Effect

This provision is expected to increase fiscal year budget receipts by $882 million in 1983, $2,235 million in 1984, $2,535 million in 1985, $2,390 million in 1986, and $2,559 million in 1987.

11. Accelerated corporate tax payments (sec. 234 of the Act and sec. 6655 of the Code)*

Prior Law

Corporations generally were required to pay 80 percent of their current year's tax liability in quarterly estimated tax payments during the taxable year.

A penalty for underpayment of estimated taxes is imposed unless the corporation meets certain exceptions based on prior year's tax liability, prior year's income, or annualized income. At each installment date, annualized income is projected from the actual taxable income earned by the end of the previous month (or quarter). Under these annualization rules, corporations with seasonal income earned primarily at the beginning of the year could upon occasion overpay estimated taxes due when they relied on the annualized income exception.

In addition, a corporation had to pay its final tax payment 2½ months after the end of the taxable year, but it could elect to pay only half of the unpaid tax on this date and the remaining half three months later.

Reasons for Change

Congress believed that corporations should not be allowed to defer a significant portion of their income tax liability until after the end of the taxable year. Allowing corporations this tax deferral amounted, in effect, to an interest-free loan from the Federal government. Therefore, Congress decided to increase the percentage of corporate tax liability that must be paid by estimated tax payments.

Congress, however, recognized that there are numerous issues of law and fact that can affect the determination of a corporation's tax liability. Because the increased estimated tax payments will demand greater precision in preparing the estimates, Congress decided to restructure the penalty so that a smaller penalty applies to the portion of the underpayment of estimated taxes that falls between 80 and 90 percent of the actual tax due, and a larger penalty to the underpayment below 80 percent.

Also, Congress realized that the present annualization exception was not providing appropriate relief in some cases, and it enacted changes to deal with this problem.

---

*For legislative background of the provision, see H.R. 4961, as reported by the Senate Finance Committee, sec. 242, S. Rept. No. 97-494, Vol. 1 (July 12, 1982), pp. 223-225; and H. Rept. No. 97-760 (August 17, 1982), pp. 551-552 (Joint Explanatory Statement of the Committee of Conference).

Explanation of Provision

The amount of estimated tax payments required for all corporations is increased from 80 percent to 90 percent of current year's tax liability. A corresponding change is made in the exception based on annualized income. The Act retained the exception that allows a small corporation to base estimated tax payments on prior year's income. For this purpose, a small corporation is defined as a corporation having less than $1 million of taxable income in each of the three prior taxable years.

The penalty on underpayments of estimated tax that are between 80 percent and 90 percent of the actual tax due is imposed at three-quarters of the full rate for underpayments.

The full amount of the unpaid tax is due 2½ months after the end of a taxable year.

A new rule for annualizing income is provided for corporations with seasonal income. Taxpayers may rely on the new rule if, in the preceding three taxable years, taxable income for any period of 6 successive months averaged 70 percent or more of total income for the taxable year. Income may be annualized by assuming that the income is earned, in the current year, in the same pattern as in the three preceding taxable years. This rule requires that the tax be paid on the annualized income in the same seasonal pattern in which it is earned.

For the annualized income exceptions, Congress intended that the Treasury amend its regulations regarding the computation of taxable income for the period before the installment due date. Taxpayers will be able to rely on these regulations in computing taxable income for a period of less than a full taxable year under the annualization and seasonal pattern of income exceptions to the underpayment penalty. Many items which substantially affect taxable income cannot be determined accurately by the installment due date. Examples of these items include (but are not limited to) the LIFO index for taxpayers using the dollar-value LIFO inventory method, the deferred gross profit for taxpayers with revolving charge accounts, intercompany adjustments for taxpayers who file consolidated returns, and a temporary liquidation of a LIFO layer at the installment date.

To alleviate these problems for taxpayers who rely on the annualized income exception, Congress expected the Secretary to issue regulations which would provide that estimates of certain items could be used where reasonable estimates could be made from existing data. For example, taxpayers using the dollar-value LIFO method of accounting might be allowed to interpolate from an available inflation index for a previous period in calculating the cost of goods sold in a period of less than a full taxable year if no reliable inflation index is available for the period for which taxable income must be calculated. Congress also understood that the Secretary would issue regulations clarifying the meaning of taxable income in regard to net operating loss carrybacks and carryforwards for purposes of defining a large corporation (under sec. 6655(h)(2)).

Effective Date

The amendments made by this section will apply to taxable years beginning after December 31, 1982.

Revenue Effect

This provision is estimated to increase budget receipts by $1,048 million in fiscal year 1983, $3,025 million in fiscal year 1984, $791 million in fiscal year 1985, $755 million in fiscal year 1986, and $484 million in fiscal year 1987.

12. Amortization of original issue discount on bonds (sec. 231 of the Act and secs. 163 and 1232 and new sec. 1232A of the Code)*

Prior Law

Tax treatment of corporate original issue discount bonds

Normally, a bond is issued at a price approximately equal to the amount for which the bond will be redeemed at maturity, and the return to the holder of the bond is entirely in the form of periodic interest payments. However, in the case of original issue discount (OID) bonds, the issue price is below the redemption price, and the holder receives some or all of his return in the form of price appreciation. The spread between the issue price and redemption price is the original issue discount. The extreme case of an OID bond is a zero coupon bond, on which there are no periodic interest payments, and the holder's entire return comes from price appreciation.

Under prior law, for bonds issued by a corporation and for which the period between the issue date and the stated maturity date exceeded one year, the original issue discount was treated as accruing in equal monthly installments over the life of the bond. Thus, an issuer of an OID bond deducted, as interest, both any periodic interest payments and a ratable portion of the original issue discount each year, and the holder of the bond included this same amount in income. For example, if a corporation issued a $1,000, 25-year bond paying a $70 annual coupon for an issue price of $500, it would deduct $90 for each full year over the life of the bond ($70 annual coupon plus 1/25th of the $500 original issue discount). The original holder of the bond would also report $90 of income for each full year he held the bond. The basis of the bond in the hands of the holder was adjusted for the discount required to be included in income. Amounts included in income as original issue discount for each purchaser after the original holder were reduced by spreading any purchase premium (the excess of the purchase price over the issue price plus previous OID income inclusions) over the remaining life of the bond and deducting it on a ratable monthly basis from OID included in income.

For corporate bonds for which the period between the issue date and the stated maturity date was one year or less, the holder did not accrue income ratably; instead, gain on sale or exchange, or redemption, was treated as interest income to the extent of what would have been the accrued OID.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 236; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 209-214; Senate floor amendments, 128 Cong. Rec. S9018 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 553 (Joint Explanatory Statement of the Committee of Conference).

Also, see H.R. 6056, Technical Corrections Act of 1982: House floor amendments, 128 Cong. Rec. H9600-9604; H. Rep. No. 97-986 (Dec. 21, 1982), pp. 2021 (Joint Explanatory Statement of the Committee of Conference).

Prior statutory rules explicitly prescribed the treatment of OID only with respect to holders of corporate and taxable government obligations that were capital assets in the hands of the holder (sec. 1232). The rule for holders of short-term corporate bonds was in section 1.1232-3A(b)(2) of the income tax regulations. For corporate issuers, the analogous rules governing the deduction of OID were prescribed by section 1.163-4 of the income tax regulations. The treatment of issuers prescribed by the regulations applied to both cash and accrual basis issuers. This regulatory treatment of corporate issuers achieved substantial parity of treatment between issuers and the holders of corporate bonds, who were required by section 1232 to include OID in taxable income ratably over the life of the bond.

Tax treatment of noncorporate original issue discount bonds

The statutory rules applicable to holders of OID bonds (sec. 1232) did not require OID on noncorporate bonds to be included in income ratably over the life of the bond. For government bonds, such rules required ordinary income treatment of the portion of any gain from the sale or redemption consisting of accrued OID. A cash basis holder of noncorporate bonds deferred the inclusion of OID in income until the bond was sold or redeemed.

Example comparing corporate OID and ordinary bonds

Assume a 15-percent interest rate. Suppose a business wants to borrow $1 and then borrow at the end of the year to pay all interest charges for the year, and repeat this sequence each year for 30 years. Its interest payments would be 15 cents in the first year, 17.3 cents the second year (15 percent interest on the outstanding balance of $1.15), and so on, and would grow exponentially, eventually equaling $8.64 in the 30th year. At the end of 30 years, the overall debt would mount up to $66.21. A total of $65.21 in interest would be paid, and deducted, over the period, but the deductions would start small and grow.

The taxpayer could achieve the same substantive result by issuing a zero-coupon bond at a price of $1 redeemable for $66.21 in 30 years. However, by using the OID bond, the taxpayer could obtain a deduction of $2.17 each year ($65.21 divided by 30). Thus, the OID bond allowed larger interest deductions in early years than borrowing the same amount with ordinary loans. In this example, the taxpayer deducted in the first year more than twice the amount borrowed and more than 14 times the real interest. Conversely, the purchaser of the OID bond included more interest in his income in early years than the purchaser of an ordinary bond.

Table 1 shows the different patterns of deductions for the issuer and income inclusion for the holder between a zero-coupon bond and borrowing with ordinary loans under prior law.

TABLE 1.—COMPARISON OF INTEREST DEDUCTIONS AND INCOME INCLUSION BETWEEN BORROWING $1 WITH ZERO-COUPON BONDS AND WITH ORDINARY LOANS UNDER PRIOR LAW

[Dollars]

Year	Ordinary loans	Zero-coupon bond	Difference
1982	0.150	2.174	2.024
1983	.173	2.174	2.001
1984	.198	2.174	1.976
1985	.228	2.174	1.946
1986	.262	2.174	1.912
1987	.302	2.174	1.872
1988	.347	2.174	1.827
1989	.399	2.174	1.775
1990	.459	2.174	1.715
1991	.528	2.174	1.646
1992	.607	2.174	1.567
1993	.698	2.174	1.476
1994	.803	2.174	1.371
1995	.923	2.174	1.251
1996	1.061	2.174	1.113
1997	1.221	2.174	.953
1998	1.404	2.174	.770
1999	1.614	2.174	.560
2000	1.856	2.174	.318
2001	2.135	2.174	.039
2002	2.455	2.174	−.281
2003	2.823	2.174	−.649
2004	3.247	2.174	−1.073
2005	3.734	2.174	−1.560
2006	4.294	2.174	−2.120
2007	4.938	2.174	−2.764
2008	5.679	2.174	−3.505
2009	6.530	2.174	−4.356
2010	7.510	2.174	−5.336
2011	8.636	2.174	−6.462
Total	65.212	65.212	0
Present value (computed at 8.1 percent after-tax rate)	11.738	24.245	12.505

Assumptions for Table 1—

Ordinary bond: Taxpayer borrows $1 in 1981 and borrows every year to pay the interest on the outstanding indebtedness. Interest rates remain at 15 percent. All debt repaid in 2011.

Zero-coupon bond: Taxpayer issues bond for price of $1 with no coupon, maturing in 30 years at a price of $66.21 (15-percent yield to maturity).

Reasons for Change

The larger deductions allowed to issuers of OID bonds in the early years of a bond's term relative to deductions allowed issuers of interest-bearing bonds not issued at a discount were a substantial tax advantage to the former, an advantage that increased with the term of the bonds. The ratable OID amortization formula was adopted at a time when interest rates were considerably lower than at present and when the formula involved a much smaller distortion. The formula was significantly different from the formula which issuers use to compute interest deductions on financial statements and did not represent a proper measurement of interest costs to the issuer. There was no justification for providing what was, in effect, a tax incentive for issuing long-term OID bonds.

Moreover, the larger income inclusion for OID bond purchasers in early years, relative to purchasers of nondiscount bonds, unjustifiably penalized those who wished to take advantage of the opportunity the OID bond provides to guarantee the reinvestment of the interest payments at the bond's initial yield to maturity. Under prior law, only tax-exempt borrowers, such as pension funds, could avoid this penalty.

Congress also believed that the treatment of holders of OID bonds should be comparable, whether the bonds are corporate or noncorporate obligations, and that the treatment of taxable, noncorporate issuers of OID bonds should be comparable to the treatment of corporate issuers.

Explanation of Provision

The Act provides new rules for computing the method of amortizing original issue discount, using a method that parallels the manner in which interest would accrue through borrowing with interest-paying, nondiscount bonds.

Under the formula prescribed in the Act, the OID is allocated over the life of the bond through a series of adjustments to the issue price for each "bond period." The adjustment to the issue price for any bond period is determined by multiplying the adjusted issue price (i.e., the issue price as increased by adjustments prior to the beginning of the bond period) by the bond's yield to maturity and then by subtracting the interest payable during the bond period.[1] The adjustment to the issue price for any bond period is the amount of the OID allocated to that bond period.

Except as regulations may provide otherwise, a bond period for any given bond is each one-year period beginning on the date of issue of the bond and each anniversary thereof, or the shorter period to maturity for the last bond period. The increase in the adjusted issue price for any bond period is allocated ratably to each day in the bond period.

Each bondholder must include in income the sum of the daily portions of OID so determined for each day during the taxable year the bond is held. When the taxable year of a holder overlaps more than one bond period (which will generally be the case unless the bond period happens to coincide with the holder's taxable year), the holder must include the appropriate daily portions for each of the relevant bond periods. The daily portions of OID includible in income or deductible will be reflected in the current earnings and profits of corporate bondholders and issuers.

As under prior law, an offset to the amount included in income is allowed for subsequent holders purchasing at a price exceeding the issue price plus the daily portions of OID for all days prior to the purchase. For this purpose, such excess purchase price is allocated over the total number of days commencing with the purchase date through the day before the date of maturity. The transferee, not the transferor, is required to take into income the daily portion for the date of transfer.

---

[1] Assume that a bond is issued at a price P_0, pays an annual coupon i, and is redeemable in N years for a price of one dollar. The yield to maturity (r) is the solution to the following equation:
$P_0 = i/r[1 - 1/(1+r)^N] + 1/(1+r)^N$

The adjustment to the issue price in the first bond year is given by $P_1 - P_0 = rP_0 - i$.

In general, if the adjusted issue price at the beginning of bond period t is P_{t-1}, the increase in the adjusted issue price during that bond period will be $P_t - P_{t-1} = rP_{t-1} - i$.

The bond holder will include in income, and the bond issuer will deduct, the increase in the adjusted issue price plus the cash interest. For bond period t, this will be rP_{t-1}.

Regulations are authorized to prescribe rules for the proper income inclusion where, because of varying interest rates, put or call options, or other circumstances, the statutory formula does not provide an inclusion that accurately reflects the income of the holder. This will include, among other cases, an early redemption where, at the time of original issue, there was an intention to call before maturity (the case covered by sec. 1232(a)(2) (A) and (B) of prior law).

The new rule governing corporate OID bonds is extended to obligations issued by noncorporate issuers other than natural persons. The OID income inclusion rules will thus apply to taxable discount government obligations and, for example, to discount obligations issued by a partnership after July 1, 1982. As under present rules for corporate bonds, the new OID income inclusion rules will apply only to bonds with a maturity date more than one year after the issue date. For bonds with a maturity of one year or less, gain on sale or redemption will be treated as interest income to the extent of what would have been accrued OID. However, tax-exempt bonds, United States Savings Bonds, and Treasury bills will be excluded from the new rules.

Congress intended that the new nonlinear formula for accrual of OID also apply for purposes of determining and withholding the 30-percent tax on foreign persons (secs. 871, 881, 1441 and 1442) and, where appropriate, in determining accrual of interest on State and local government bonds.

The existing rule requiring ratable monthly inclusion of OID on corporate bonds will be continued for bonds issued before July 2, 1982.

The new rules and the rules continuing prior law for pre-July 2, 1982, corporate bonds are both included in a new Code section 1232A. As under prior law, the basis of a bond will be increased for OID included in income, and the prior law exceptions are continued for bonds purchased at a premium and bonds held by a life insurance company to which section 818(a) applies. As in the case of corporate OID bonds under prior law, the new income inclusion rules for OID apply only to bonds that constitute capital assets in the hands of the holder. The definitional rules of section 1232(b) continue to apply to the determination of original issue discount.

The aggregate daily portions of OID determined under the new rules that accrue during the taxable year of the issuer are the amount that the issuer may deduct. For this purpose, the deduction is limited to the sum of the daily portions of OID accruing during the issuer's taxable year without regard to any offset available to transferee holders. The deduction for OID under the new rule applies to certain tax-exempt industrial development bonds resulting in interest deductions to a taxable issuer. The rules governing the deduction for OID will be added to the Code (new sec. 163(e)). The deduction for OID will apply to all issuers of OID obligations (other than natural persons) regardless of whether the issuer uses the cash or the accrual method of accounting.

Original issue discount may accrue on construction period loans. If an amount otherwise deductible during the construction period as original issue discount under section 163(e) is subject to capitalization under section 189, deductions will be allowable to the extent and for the taxable years determined under section 189.

The Act retains the rules of prior law that require gain from the sale or redemption of corporate bonds issued on or before May 27, 1969, and government bonds not subject to the new OID rules (those issued or treated as issued, under the binding commitment rule, before July 1, 1982) to be treated as ordinary income to the extent of OID. Otherwise, prior law continues to define corporate and government bonds as capital assets, gain or loss from the sale or redemption of which constitutes capital gain or loss.

Effective Date

The new rules apply to bonds issued after July 1, 1982, other than those issued under a written binding commitment entered into before July 2, 1982. A written binding commitment involves a commitment by the issuer to issue the bonds at a particular price. Thus, for example, the new rules do not apply in cases where bonds are issued pursuant to the exercise of warrants which were outstanding on July 1, 1982.

Revenue Effect

This provision is expected to increase fiscal year budget receipts by $107 million in 1983, $222 million in 1984, $359 million in 1985, $502 million in 1986, and $655 million in 1987.

13. Stripping of interest coupons from bonds (sec. 232 of the Act and new sec. 1232B of the Code)*

Prior Law

The holder of a bond or other debt instrument who sells the bond with coupons attached between interest dates receives interest income to the extent of interest accrued to the date of sale, and the remainder of the sales proceeds is in exchange for the bond. This treatment is prescribed by section 1.61-7 of the income tax regulations. The bond holder may instead strip the unmatured interest coupons from the bond and dispose of either the coupons or the corpus of the bond (i.e., the right to receive the principal amount of the bond at maturity), or both the coupons and the corpus in separate transactions.

It is arguable under prior law that all of the taxpayer's basis in the debt instrument was allocated to the corpus, in which case a taxpayer who sold the corpus and retained the coupons could claim a loss on the sale of the stripped corpus equal to the difference between the amount for which he bought the debt instrument (with coupons attached) and the amount received for the corpus (without coupons). The loss, if allowable, would generally be an ordinary loss if the taxpayer was a dealer in such obligations or a bank. Otherwise, any loss allowable would be a capital loss.

For the person who bought the stripped corpus, gain on any later sale, or on redemption, of the stripped corpus was ordinary income to the extent of the difference between what would have been the value of the obligation with coupons attached at the time of its purchase and the actual cost of acquisition. For the purchaser of detached coupons, the coupons were a capital asset. The portion of the purchase price equal to the interest accrued to the date of purchase and taxed to the seller was, upon payment, a recovery of capital reducing the buyer's cost basis. Gain on the sale of the coupons may have been treated as a capital gain. However, if the coupons were redeemed, the purchaser of the coupons had ordinary income equal to the difference between the amount received on redemption of each coupon and the purchase price allocable to that coupon.

Most coupon-stripping transactions involved U.S. government or agency obligations, but they could have involved tax-exempt obligations or taxable bonds issued by the private sector. For example, assume that a broker-dealer sold a $100,000 U.S. Government 20-year coupon bond with coupons detached for $8,000 immediately after the bond was issued. The $92,000 under prior law might constitute an ordinary loss to the seller. Also, the buyer of the stripped corpus who held it until maturity would report no income until maturity, when he or she would report $92,000 of ordinary income. Thus, there was a tax deferral on $92,000 of income.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 237; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 215-218; Senate floor amendments, 128 Cong. Rec. S9018 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 554, 555 (Joint Explanatory Statement of the Committee of Conference).

There was also a tax benefit to a purchaser of detached, unmatured interest coupons. In substance, each coupon is like an original issue discount bond, which should be subject to periodic inclusion rules. Under prior law, income was deferred until the coupon was sold or redeemed.

Reasons for Change

Coupon stripping could permit income tax deferral through an artificial loss from selling the stripped bond, analogous to the deferral formerly accomplished through straddles that was eliminated by the Economic Recovery Tax Act of 1981 (Code secs. 263(g), 1092, and 1256). Deferral through coupon stripping should be subject to the same policy that eliminated deferral through straddles. Further, allocating the entire cost of an obligation with interest coupons to the corpus when a stripped bond or interest coupons are disposed of is economically unrealistic.

Upon disposition of the stripped corpus or the detached, unmatured coupons, both the retained portion and the portion disposed of represent the right to a fixed amount payable at a future date that is purchased at a discount. Congress believed that the periodic original issue discount (OID) inclusion rules applicable to obligations issued at a discount provide the appropriate tax treatment.

Explanation of Provision

The Act provides new rules under which, when a disposition separates ownership of a bond from the coupons detached from it, the stripped corpus and detached coupons are treated as OID bonds issued by a corporation on the date of disposition and are subject to the periodic income inclusion rules applicable to those bonds.

For the purchaser of a stripped bond, the excess of the stated redemption price at maturity over the portion of the purchase price allocable to the bond is the OID allocable to the purchased bond. It must be included in income periodically (under the new rules provided in section 231 of the Act) between the date of purchase and the date the bond matures. For the purchaser of a stripped coupon, the OID is the excess of the amount payable on the due date of the coupon over the portion of the purchase price allocable to the coupon. It must be included in income periodically (under the new OID inclusion rules) between the date of purchase and the due date of the coupon. The ratable share of the purchase price allocable to the corpus or a coupon is determined on the basis of their respective fair market values on the date of purchase.

The seller of a stripped bond or stripped coupons must allocate the basis, immediately before the disposition, of the bond with coupons attached between the items retained and the items disposed of. Subsequent to the disposition, the seller is required to treat the retained items as OID bonds each of which has a purchase price equal to the amount of basis allocated to that item. Similar rules apply to a person whose basis in a bond or coupon is determined by reference to the basis in the hands of a purchaser or seller of a stripped bond or stripped coupons.

The Act provides a special rule to deal with interest that has accrued on the bond at the time the taxpayer strips a bond or a coupon. Under this rule, interest accrued on the bond while the taxpayer holds the bond must be included in taxable income at the time the stripping occurs (just as would be the case had the entire bond been sold), and the taxpayer increases his basis in the bond by the amount of that accrued interest. This adjusted basis is then allocated between the corpus and the coupons in relation to their respective fair market values. Accrued interest required to be included in income under this rule does not include interest previously included in income (e.g., by an accrual basis taxpayer).

Under the new rules, no artificial loss can be created by selling a stripped bond with a basis reflecting value attributable to detached coupons. However, proceeds from the sale of stripped coupons will not constitute income to the seller to the extent that the seller's basis in the bond with coupons attached is allocated to the detached coupons. Instead, the retained items (either the detached coupons or the stripped corpus), to the extent that the price payable on maturity, or on the due date of the coupons, exceeds the portion of the seller's basis allocable to such retained items, will be treated as OID bonds requiring the seller to include OID in income under the new OID periodic income inclusion rules.

For the purchaser of a stripped bond, the excess of the redemption price over the purchase price must be taken into income under the new OID income inclusion rules but will not be subject to the requirement of prior law converting gain on sale or redemption into ordinary income to the extent the purchase price was reduced because coupons were detached. The buyer of detached coupons must also take the excess of the price payable on the due date of the coupon over the purchase price into income under the new OID income inclusion rules and thus will be unable to defer and convert earned discount income into capital gain by selling coupons before they mature.

For taxable stripped bonds purchased before the effective date of the new rules, the Act continues the rule of prior law requiring ordinary income treatment for gain on a sale or redemption of a bond corpus attributable to the difference in value of the bond with and without coupons attached at the time of purchase. For tax-exempt obligations, this rule of prior law is preserved for bonds purchased after the effective date. The new OID income inclusion rules do not apply in the case of tax-exempt stripped bonds. However, the rule requiring a seller of a stripped bond or detached coupons to allocate the basis of the bond with coupons attached between the items retained and those disposed of applies to a tax-exempt bond. Thus, as in the case of taxable obligations, the seller of a stripped tax-exempt obligation will be unable to create an artificial loss because basis is allocated to retained coupons under the rules. Also, if tax-exempt coupons are separately sold, gain on sale or redemption of the retained stripped bond that is attributable to allocation of a portion of the seller's basis to the detached coupons will be taxable as ordinary income.

The new rules providing the tax treatment for stripped bonds are included in a new Code sec. 1232B. For purposes of applying these rules, a bond includes a debenture, note, or other evidence of indebtedness, a "stripped bond" is defined as a bond issued with interest coupons where there is a separation in ownership between the bond and any unmatured coupon, a "stripped coupon" is defined as any coupon relating to a stripped bond, the "stated redemption price at maturity" has the same meaning as in existing law (sec. 1232(b)(1)), and the term coupon, where a purchase occurs after July 1, 1982, includes any right to receive interest on a bond (whether or not evidenced by a coupon). No inference was intended as to the interpretation of the term "coupon" in prior law section 1232(c).

The Act repeals prior law section 1232 (c) and (d) relating, respectively, to the requirement of ordinary income treatment of bonds with unmatured coupons detached and a cross-reference for special treatment of face-amount certificates.

The Act also provides the Secretary of the Treasury with the authority to issue regulations to provide the appropriate basis allocation and income inclusion rules in cases where the general rules in the statute do not provide a proper determination of income by reason of call provisions, extendable maturities, etc. For example, in the case of callable bonds with coupons redeemable after the call date, these regulations could provide that no basis need be allocated to post-call coupons as long as they remain attached to the corpus and that there be no periodic inclusion of discount income with respect to post-call coupons where this is appropriate.

A technical correction will be necessary to treat stripped bonds and stripped coupons in the hands of nonresident aliens and foreign corporations when such instruments produce income that is not effectively connected with a U.S. trade or business in a manner consistent with the treatment of such instruments in the hands of U.S. persons.

Effective Date

The rules apply generally where there is a sale after July 1, 1982, of either a stripped bond or stripped coupons.

Revenue Effect

This provision is expected to increase fiscal year budget receipts by $56 million in 1983, $88 million in 1984, $106 million in 1985, $127 million in 1986 and $153 million in 1987.

14. Extension and revision of targeted jobs credit (sec. 233 of the Act and sec. 51 of the Code)*

Prior Law

The targeted jobs credit was available, on an elective basis, for hiring individuals from one or more of nine target groups. The credit is equal to 50 percent of the first $6,000 of wages paid for the first year of employment and 25 percent of the first $6,000 of wages paid for the second year of employment to a target group individual.

The credit was available for wages paid to eligible individuals who began work for the employer before January 1, 1983.

An authorization of $30 million of appropriations was provided for fiscal year 1982 for the expenses of administering the certification system and of providing publicity to employers; $5 million of the amount appropriated was to be used to verify the certification of target group members, using methods such as the in-depth verification of eligibility for a sample of certified individuals.

An individual was a member of a targeted group if the individual was:

(1) an economically disadvantaged youth aged 16 through 19 participating in a cooperative education program,

(2) a recipient of money payments under a State or local general assistance program,

(3) an economically disadvantaged youth aged 18 through 24,

(4) a handicapped individual undergoing vocational rehabilitation,

(5) an economically disadvantaged Vietnam-era veteran,

(6) an SSI recipient,

(7) an economically disadvantaged ex-convict,

(8) an AFDC recipient or work incentive employee; or

(9) an involuntarily terminated CETA employee.

An individual could not be treated as a member of a targeted group unless the employer requested or received a certification from the designated local agency before the day on which the individual began work for the employer.

Reasons for Change

Congress believed that experience with the targeted jobs tax credit had been sufficiently promising to warrant its extension. Furthermore, Congress agreed to several changes designed to make the provision more effective.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 241; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 219-222; Senate floor amendment, 128 Cong. Rec. S9018 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 667-669 (Joint Explanatory Statement of the Committee of Conference).

First, Congress believed that the credit should be extended for 2 more years.

Second, Congress decided that the targeted jobs tax credit should be modified in a manner to encourage summer youth employment of economically disadvantaged teenagers. This was accomplished by expanding eligibility and increasing the amount of the credit for the hiring of economically disadvantaged youths who are 16 or 17 years of age for any 90-day period between May 1 and September 15.

Third, Congress decided to eliminate the target group consisting of individuals involuntarily terminated from CETA jobs, since the last such termination occurred in September, 1981.

Fourth, the $30 million ceiling on the authorization of administrative funds was eliminated in order to provide greater flexibility in providing the necessary amount. However, in view of continuing concern about potential abuse in the program, Congress decided that the Secretary of Labor should submit annual quality reports to the Congress. The certification procedure was streamlined by providing that certifications are valid if requested or received on, as well as before, the day the individual begins work for the employer.

Finally, Congress decided that, with respect to the availability of the credit for general assistance recipients, recipients of non-cash, as well as cash, assistance should be eligible for certification.

Explanation of Provision

The Act extends the targeted jobs credit for 2 years, makes the credit available for summer employment of economically disadvantaged 16 and 17 year olds, and makes several administrative changes.

Extension of credit

The Act extends the targeted jobs credit for 2 more years. Under the Act, the credit is available for wages paid to individuals who begin work for the employer on or before December 31, 1984. Thus, if an eligible individual begins work on December 31, 1984, the employer may claim credit for qualified first-year and qualified second-year wages paid to that employee attributable to service performed in 1985 and 1986 respectively.

Summer youth employment

In order to encourage summer youth employment, the Act allows employers to claim a tax credit for wages paid to each youth who is certified by the designated local agency as being 16 or 17 years of age on the hiring date and a member of an economically disadvantaged family, for services attributable to any 90-day period between May 1 and September 15. The youth must not have been an employee of the employer prior to this 90-day period. With respect to any particular employer, an employee can qualify only one time for this summer youth credit.

The maximum amount of wages eligible for the credit for this target group is $3,000. The credit amount is 85 percent of eligible wages, for a maximum credit of $2,550.

If, after the end of the 90-day period, the employer continues to employ a youth who is certified during the 90-day period as a member of another target group, the limit on qualified first-year wages will take into account wages paid to the individual while he or she was a qualified summer employee. For example, suppose a qualified summer youth employee begins work for an employer on May 15 and is paid $3,000 for wages attributable to services performed during the next 90 days. During this period, the employee obtains a second certification as a member of another targeted group (for which the credit rate is 50 percent for qualified first-year wages). Since qualified first-year wages generally are limited to $6,000 for services attributable to the 12-month period beginning with the day the individual first begins work for the employer (May 15), wages eligible for the 50-percent credit are limited to $3,000 (the $6,000 limit minus the $3,000 paid to the individual as a qualified summer youth employee). A 25-percent credit for qualified second-year wages then could be claimed for wages attributable to the 12-month period beginning the following May 15. Moreover, the second certification is not invalid merely because it was requested or received after the individual begans work for the employer; only the first certification (as a qualified summer youth employee) must meet the requirement of section 51(d)(16) that a certification must be requested or received by an employer on or before the day on which the individual begins work for the employer. In addition, the second certification is to be determined on the basis of the facts on the date on which the individual is certified as a member of the second targeted group rather than on the basis of the facts on the day the individual is hired by the employer.

Definition of general assistance program for purposes of credit for hiring general assistance recipients

The Act provides that a qualified general assistance program includes a program that provides general assistance or similar assistance that is based on need and consists of certain non-cash (i.e., voucher or scrip), as well as cash, payments. As under prior law, qualified general assistance programs include only those based on need, and a recipient is a member of a targeted group only after receiving assistance for at least 30 days.

Elimination of credit for involuntarily terminated CETA employees

The target group consisting of individuals involuntarily terminated from CETA jobs is eliminated, effective for individuals who begin work for the employer after December 31, 1982.

Elimination of ceiling on authorization

The $30 million ceiling on the authorization of administrative funds is eliminated. Thus, appropriations will be authorized for such sums as may be necessary in fiscal years 1983 and 1984. Congress intended that some of these funds should be used to evaluate the effectiveness of the credit in improving the employment situation of the target groups.

Other changes

The Act requires the Secretary of Labor to submit annual quality control reports to Congress. These reports will review the accuracy of the process by which the eligibility of individuals as members of targeted groups is determined.

Furthermore, the Act provides that certifications are valid if requested or received on or before, rather than before, the day the individual begins work for the employer.

Effective Date

The extension of the targeted jobs tax credit applies to eligible individuals who first begin work for the employer after December 31, 1982.

The credit for summer youth employment applies to eligible individuals who first begin work for the employer after April 30, 1983.

The change with respect to general assistance recipients applies to eligible individuals who first begin work for the employer after July 1, 1982.

The change with respect to certifications applies to eligible individuals who first begin work for the employer after May 11, 1982.

Revenue Effect

The provision will reduce fiscal year budget receipts by $182 million in 1983, $551 million in 1984, $591 million in 1985, $271 million in 1986, and $54 million in 1987.

C. Provisions Designed to Improve Taxpayer Compliance*

1. Withholding on interest and dividends (secs. 301-308 of the Act, secs. 31, 275, 6042, 6044, 6049, 6682, 7205 and new secs. 3451-3456 of the Code)**

Prior Law

Overview

Prior law required information reporting for payments of most types of interest, dividends and patronage dividends but did not require withholding on such payments, except in the case of payments to certain foreign persons. Among the types of payments for which no information reporting was required were payments of interest on bearer obligations and exempt governmental obligations.

Withholding requirements for wages

An employer who pays wages to individual employees (or has employees who report tips) must withhold a portion of such wages to satisfy all, or part, of the employee's Federal income tax liability. The term "wages" generally is defined as all remuneration, unless specifically excluded, paid for services performed by an employee for an employer, including the cash value of all remuneration paid in any medium other than cash.

The amount to be withheld from the wages of a particular employee is determined in accordance with tables prescribed by the Secretary. Except in the case of payments to certain foreign persons, payments subject to withholding under the windfall profit tax and certain gambling winnings, there was generally no requirement under prior law for withholding on payments other than wages.

Wage withholding exemptions

Individuals whose wages are subject to withholding may be entitled to exempt their wages from withholding in $1,000 increments (exemptions). The exemptions allowed include (1) one exemption for the taxpayer; (2) one additional exemption if the taxpayer has attained, or will attain, age 65 during the taxable year; (3) one additional exemption if the taxpayer is blind; (4) an exemption for the taxpayer's spouse (and additional exemptions for age or blindness of the spouse) unless the spouse is claiming the exemptions on a separate return; (5) one additional exemption for each dependent of the taxpayer; and (6) a zero bracket amount allowance, unless the taxpayer is married and the spouse receives wages subject to withholding or the taxpayer has withholding exemption certificates in effect with respect to more than one employer. In addition to these withholding exemptions, taxpayers may be entitled to claim additional withholding exemptions for excess itemized deductions, tax credits and other items specified in Treasury Regulations.

---

*For technical amendments to H.R. 4961 as reported by the Senate Finance Committee, see 128 Cong. Rec. S9016 (July 22, 1982).

**For legislative background of the provision, see H.R. 4961, as reported by the Senate Finance Committee, secs. 301-310; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 226-237; Senate floor amendments, 128 Cong. Rec. S8644 (definition of exempt individual) (July 19, 1982); 128 Cong. Rec. S8923 (Minimal interest payment), S8944 (Exemption for certain financial institutions), S8947 (definition of patronage dividend subject to withholding), (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 560-561 (Joint Explanatory Statement of the Committee of Conference).

An individual subject to withholding may reduce or increase the number of exemptions claimed (under procedures set forth in the regulations) so that withheld taxes will more closely equal his or her anticipated tax liability. Employees who incurred no income tax liability for the preceding taxable year and expect to have no income tax liability for the current taxable year may claim total exemption from wage withholding.

Wage withholding exemption certificates

An individual may claim withholding exemptions by furnishing his or her employer with a withholding exemption certificate (Form W-4). In the case of new employment, this certificate must be furnished on or before the date employment begins. If no exemption certificate is furnished, the employee is considered as unmarried and claiming no exemptions.

When a change occurs which decreases the number of withholding exemptions which an employee is entitled to claim, the employee must furnish the employer with a new exemption certificate reflecting the correct number of exemptions. Such new certificate must be furnished within ten days after the change occurs. In addition, a new certificate is required when an employee who has claimed complete exemption from withholding can no longer reasonably anticipate no income tax liability for the current taxable year.

An employer is required to submit to the Internal Revenue Service a copy of a withholding exemption certificate received from an employee during the reporting period if (1) on the last day of the reporting period, the employee is employed by that employer and claims more than fourteen withholding exemptions, or (2) the employee claims complete exemption from withholding, unless the employer reasonably expects that the employee's wages from the employer will not usually exceed $200 a week.

Voluntary withholding on pensions

Under prior law, annuity or pension payments were subject to withholding to the extent includible in gross income if the payee so requested in writing. The amount requested to be withheld from a pension or annuity had to be at least $5 per month and could not reduce the net amount of any pension or annuity payment below $10.

The rules with respect to withholding on pensions were modified by section 334 of the Act described at item C. 5., below.

Withholding on gambling winnings

In certain circumstances, proceeds from wagers are subject to withholding at a rate of 20 percent. In general, gambling winnings are subject to withholding if the proceeds exceed $1,000 and are at least 300 times as large as the amount wagered. However, special rules apply to winnings from State-conducted lotteries and winnings from sweepstakes, wagering pools, certain parimutuel pools, jai alai, and other lotteries.

The payor of gambling winnings that are subject to withholding is required to file Form W-2G with the Internal Revenue Service Center serving the district in which the principal place of business of the person filing the return is located.

Withholding on foreign investors

In general, the U.S. source income of a nonresident alien or foreign corporation which is not effectively connected with the conduct of a trade or business in the United States is taxed by the United States at a flat rate of 30 percent (or a lower treaty rate) of the gross amount paid. This tax is collected through withholding by the person making the payment to the foreign recipient. Income effectively connected with a U.S. trade or business is not subject to the flat 30-percent tax, or to withholding, but instead is includible in the U.S. income tax return of the business and is taxed at the regular graduated rates.

Certain noneffectively connected income, such as interest from U.S. bank deposits and original issue discount on obligations maturing in six months or less, is exempt from U.S. tax and, therefore, from withholding. Also, the income of foreign governments or international organizations from investments in the United States in bonds, stocks, and other securities, or from interest on bank deposits, is exempt from U.S. tax.

Reasons for Change

The Internal Revenue Service has estimated that 15 percent of dividend income and 11 percent of interest income was not reported by taxpayers. In contrast, 99 percent of wage income was reported by taxpayers. Congress determined that the difference in compliance rates was due in large part to the fact that wages were subject to withholding while interest, dividends and patronage dividends were not. Congress believed that withholding would improve voluntary compliance for several reasons. First, once tax is withheld from an amount of income, any incentive a taxpayer had to conceal the income in preparing his return is reduced or converted to an incentive to report the income and claim the withholding credit. Second, since the taxpayer's ability to claim a credit for withheld amounts depends upon the payor accurately reporting amounts withheld, information reports submitted with respect to payments subject to withholding are significantly more accurate. Thus, the Internal Revenue Service can more easily detect noncompliance and take effective enforcement actions promptly and with a minimum of intrusion into the affairs of taxpayers and third parties. Finally, imposition of withholding serves as an effective reminder to taxpayers that the payments subject to withholding should be reported as income.

In considering whether withholding should be required on payments of interest, dividends and patronage dividends, Congress examined not only the potential for improved compliance but also the burdens on taxpayers and payors of interest, dividends and patronage dividends. Congress believed that the provisions of the Act permitting certain persons to claim exemption from withholding, combined with the flexibility permitted in the wage withholding and estimated tax systems, will prevent involuntary over-withholding or overpayment of estimated taxes. Further, Congress believed that a properly designed and administered withholding system will be substantially less intrusive than the kind of examination and collection effort that would have to be undertaken to achieve a comparable level of compliance in the absence of withholding. Finally, Congress believed that the evolution of electronic data processing in recent years will enable the private sector to process the information necessary to operate a withholding system efficiently and effectively.

Explanation of Provision

Overview

Generally, the Act provides for a system of withholding on payments of dividends, patronage dividends, and interest to individuals (other than certain low income and elderly individuals) at a rate of 10 percent. Withholding also is required on payments to unincorporated entities, such as partnerships and estates, which are not themselves required to withhold on payments to individuals. Interest subject to the withholding requirement includes most interest paid by persons other than individuals, including payments by the United States and payments on bearer obligations. Dividends subject to the withholding obligation include most of the distributions of money or property by a corporation to its shareholders out of its earnings and profits that were subject to information reporting under prior law. Withholding is also required on certain payments of patronage dividends by cooperatives.

Exemptions from withholding are specifically provided for (1) payments to individuals who had tax liability in the preceding year of $600 or less ($1,000 in the case of a joint return), (2) payments to persons age 65 or older whose tax liability in the preceding year was $1,500 or less ($2,500 in the case of a joint return), (3) payments to trusts that must distribute all of their income currently, if all the beneficiaries are individuals who could qualify as exempt individuals on the basis of their prior year's tax liability, or exempt organizations or individual retirement plans, (4) certain payments by consumer cooperatives, (5) payments to corporations, governments, security dealers, money market funds, exempt organizations, and nominees or custodians, and (6) at the payor's election, payments which do not exceed $150 and which would not exceed $150 on an annual basis.

The Act provides that, in implementing the withholding requirements, the Treasury is to take into account the costs incurred by payors in instituting withholding. Specifically, the Treasury is to structure rules for paying withheld taxes over to the Treasury which take into account the start-up costs of withholding agents. Further, the Secretary may exempt any payor from the withholding requirement, but not beyond 1983, if complying with the requirement prior to 1983 would impose an undue hardship on the payor.

Obligation to withhold

Under the Act, every payor paying or crediting interest, dividends, or patronage dividends must withhold an amount equal to 10 percent of the payment. The term "payor" includes, to the extent provided in regulations, (1) any custodian for, or nominee of, the payee, (2) any corporate trustee of a trust, which is the payee, or (3) any other person who collects a payment for the payee or otherwise acts as a middleman between the payor and the payee. To the extent provided in regulations, middlemen will be treated as having paid the amount received as a middleman to the payee upon receipt by the middleman. Further, the Secretary may prescribe regulations under which a fiduciary or agent with respect to the payment or crediting of any interest, dividend or patronage dividend, or any other person who has control, receipt, custody, or disposal of, or who pays or credits any interest, dividends, or patronage dividends, is designated as a payor.

Any person who is a payor, or any payor, or any person designated as a payor under regulations, is treated as the payor for all purposes of withholding, including penalties. However, the Secretary may prescribe regulations under which any payor may be relieved of the withholding requirement with respect to any amount if that amount has been withheld upon by another payor. For example, the regulations would not require withholding on a payment to a local bank which had already withheld on a payment of interest made to an individual at the time the local bank redeemed an interest coupon. Such regulations could require that the payor comply with appropriate information reporting requirements in order to be relieved from the withholding obligation. Thus, for example, if a corporation issues a debt obligation which is held by an individual, the corporation, as payor, will be required to withhold on the payment of interest to the individual. However, if the obligation is held by a brokerage firm which is a partnership for the benefit of an individual, the corporation need not withhold on its payment to the middleman brokerage firm, but the firm will withhold from its payment to the individual.

Because the definition of interest subject to withholding excludes interest on obligations of natural persons, individuals will not be withholding agents unless they act as nominees or custodians for other individuals.

Generally, the tax must be withheld when the interest, dividends, or patronage dividends are paid or credited to the payee unless otherwise provided in the Code or regulations.[1] Thus, for example, if a payor pays interest every six months, withholding will be required twice a year. If, however, a payor credits interest to a customer every month, then the payor will be required to withhold monthly. The Act does not require payors of interest or dividends to alter the system under which they presently credit payments to payees. Rather, the Act simply requires that whenever a payor does pay or credit interest or dividends to its payees, it must deduct and withhold the 10-percent withholding tax.

---

[1] Subsequent amendments were made to the withholding rules by the Subchapter S Revision Act of 1982, Public Law 97-354, effective for taxable years beginning after 1982. Under the Subchapter S Revision Act, Subchapter S corporations receiving a payment (for credit) subject to withholding may, under regulations, be treated as payors for withholding purposes. To the extent provided in regulations, any Subchapter S corporation treated as a payor would also be treated as having paid the amount received by, or credited to, its shareholders on receipt thereof. If one or more of the corporation's shareholders are exempt recipients, no withholding would be required with respect to that payment if the shareholder furnished any necessary certifications.

Banks, savings institutions and similar organizations including credit unions, are permitted to elect, under regulations, to defer withholding on payments of interest (whether or not denominated "dividends") on deposits in certain savings and checking accounts and similar accounts, such as credit union share accounts, which have the characteristics of checking accounts (such as the ability to write drafts against any portion of the account balance without penalty or limitation), until a date not later than the last day of the calendar year in which the payment is made. It was anticipated that the regulations describing this election will require (subject to the Secretary's authority to allow withholding from alternative sources) that the payor agree that the balance in any account for which the election is made will not be permitted to fall below the amount of tax that would have been deducted and withheld up to the day of withdrawal in the absence of the election. The payor also will be required to accelerate the deduction and withholding of tax with respect to accounts for which the election is made when the account is closed prior to the date elected for deducting and withholding tax. It was anticipated that the payor will be required tc make this election with respect to all accounts of the same category.

Exemptions from withholding

The Act provides for four explicit exemptions from the withholding requirement with respect to interest, dividends, and patronage dividends. These exemptions are for (1) payments to certain low income and elderly individuals (including certain trusts treated as exempt individuals), (2) payments to exempt recipients such as corporations and nominees, (3) certain payments by consumer cooperatives, and (4) if the payor so elects, any payment which does not exceed $150 and which would not exceed $150 if made on an annual basis.

Exempt individuals.—The Act provides for an exemption from withholding on payments to certain exempt individuals. An exempt individual is any individual who has a valid exemption certificate in effect and whose Federal income tax liability for the preceding taxable year did not exceed $600 ($1,000 in the case of a joint return) or who is 65 years of age or over and whose income tax liability for the preceding taxable year did not exceed $1,500 ($2,500 in the case of a joint return). If either spouse filing a joint return is age 65 or over, both spouses are considered age 65 or over for this purpose. Under these exceptions, for example, a couple both of whom are over 65 and who do not itemize deductions will be exempt from withholding unless their gross income exceeds approximately $22,214 (under 1982 tax rates). Regulations may provide that a trust will be treated as an exempt individual if all its income beneficiaries are exempt individuals, exempt organizations or individual retirement plans and all the income of the trust must be distributed currently.

Other exempt recipients.—The Act also provides that no withholding is required on payments to (1) a corporation, (2) an organization exempt from taxation under section 501(a) or an individual retirement plan, (3) the United States or a State or local government (including a political subdivision, or agency or instrumentality thereof), (4) a foreign government or international organization, (5) a foreign central bank of issue, (6) a dealer in securities or commodities required to register as such under the laws of the United States or any State, (7) a real estate investment trust (as defined in section 856), (8) an entity registered at all times during the taxable year under the Investment Company Act of 1940, as amended, (9) a common trust fund (as defined in section 584(a)), (10) a nominee or custodian except as otherwise provided in the regulations, (11) to the extent provided in regulations, any financial institution, broker, or other person which collects payments subject to withholding for the payor, or otherwise acting as a middleman between the payor and payee, or, (12) any charitable remainder annuity trust or charitable remainder unitrust or trust described in section 4947(a)(1). In any case, a recipient will not be treated as exempt unless a valid exemption certificate is in effect, or the requirement of the exemption certificate is excused by regulation.

However, every payor is permitted to require certification by exempt recipients. Thus, if a payor does not wish to rely on its own judgment that a payee is exempt, it may require a certificate. Payors are not required to look behind an exemption certificate valid on its face or investigate such an exemption certificate's actual validity.

Exemption certificates.—The Act requires the Secretary to provide a method by which exempt individuals and other exempt recipients may at any time certify to their payor that withholding is not required on payments to them. The regulations providing for exemption certificates will, therefore, provide rules governing (1) the form of the certification, (2) the time at which the certificates become effective, and (3) the transmittal of copies of the certificate to the Secretary. It was anticipated that the Secretary would require that the certificate contain a taxpayer identifying number that appears to be proper in order for the certificate to be effective. An exemption certificate, once filed, will remain in effect until the payee revokes the certificate, or the Secretary notifies the payor that the payee is not entitled to exemption. The Secretary also will provide rules allowing the payor adequate time to respond to a change in the recipient's status as exempt or nonexempt.

Qualified consumer cooperative payments.—Under the Act, withholding is not required on any qualified consumer cooperative payment. Such a payment is any payment by an organization taxable as a cooperative which the Secretary determines is engaged primarily in selling at retail goods and services of a type that are generally for personal, living, or family use and which the Secretary has exempted from the reporting requirements of section 6044(a) pursuant to the authority of section 6044(c).

Minimal interest payments.—The Act provides that the Secretary may prescribe regulations under which payors may elect not to withhold on payments of interest which do not exeed $150 and which would not exceed $150 on an annual basis. In determining whether the $150 limit has been reached in any particular case, regulations may require that payment of interest by the payor to any single payee must be aggregated. Under this election, for example, a payor who paid interest quarterly would not have to withhold on payments to a payee of $37.50 or less. This would be true even if the current payment added to preceding payments for that year would exceed $150.

Credit for withheld amounts

Under the Act, amounts deducted and withheld from interest, dividend, or patronage dividend payments are creditable against the income tax liability of the recipient of the income. The credit is allowed for the taxable year of the recipient of the income in which the amount is received.[2] In the case of amounts withheld on payments to estates or trusts, the income of the estate or trust beneficiaries is grossed up for the credit allocated to each beneficiary. The credit is allocated between the trust or estate and income beneficiaries according to the amount of interest, dividend, or patronage dividend income allocable to each under the income tax.

Since withheld amounts are treated as amounts withheld on wages, the amounts withheld on interest, dividends and patronage dividends will reduce the taxpayer's estimated tax payment obligations. In addition, taxpayers will receive refunds of any amounts withheld that exceed liability for income tax in the same manner in which they receive refunds of excess withholding from wages.

Deposit of tax

Under prior and present law, the Secretary is granted authority to prescribe the manner, times, and conditions under which deposits of any tax imposed under the internal revenue laws may be made with a depository or financial agent of the United States. In addition, the Secretary is authorized to determine the manner, times, and conditions under which receipt by such depositories of such tax will be treated as a payment of the tax to the Secretary. It was anticipated that the Secretary would provide for rules on the time for making deposits of withheld taxes that take into account the costs of implementing this withholding system. Specifically, Congress anticipated that all payors of interest, dividends, and patronage dividends will be permitted up to an average of 30 calendar days (or an equivalent number of banking days) in which to deposit withheld amounts. This extended deposit period should apply for payments withheld during the period from July 1, 1983, to June 30, 1984. A similar extended period should apply through June 1985 for small and medium financial institutions and through June 1986 with respect to amounts withheld on interest paid on deposits with small institutions.

Amounts subject to withholding

Interest.—Interest payments subject to withholding are payments of (1) interest on any obligation which is issued in registered form, or which is of a type offered to the public; (2) interest on deposits with persons carrying on the banking business; (3) amounts (whether or not designated as interest) paid by a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, industrial loan association or bank, or similar organization in respect to deposits, investment certificates, or withdrawable or repurchaseable shares; (4) interest on amounts held by an insurance company under an agreement to pay interest thereon; (5) interest on deposits with brokers as defined in section 6045(c); (6) interest paid on amounts held by investment companies (as defined in sec. 3 of the Investment Company Act of 1940), and on amounts invested in other pooled funds or trusts. Amounts paid as a substitute for an interest payment to a taxpayer whose bond was borrowed (for example, in a short sale) are treated as interest for purposes of withholding. For purposes of the withholding provision interest does not include interest on any obligation issued by a natural person.

---

[2] The rule stated in text reflects amendments made by the Technical Corrections Act of 1982.

This definition of interest for withholding purposes is subject to numerous exceptions designed to insure that withholding does not occur with respect to interest that is not subject to taxation by the United States. Specifically, the term interest does not include any interest which is exempt from taxation under Code section 103 or any interest exempt from tax under any other provision of law, if such interest is exempt from tax without regard to the identity of the holder. Similarly, amounts paid on any depository institution tax exempt ("all-savers") certificates are not subject to withholding. Payments to foreign persons generally are excluded from the definition of interest subject to withholding if the recipient is exempt from U.S. taxation on such income or if the payment is of a type subject to the 30-percent tax on payments to non-resident aliens and foreign corporations or the withholding tax on tax-free covenant bonds. Thus, interest does not include income of a foreign government or international organization that is exempt under section 892 or income of a foreign central bank of issue derived from obligations of the United States or from bank deposits that is exempt under section 895. In addition, interest does not include any amount that is subject to the 30-percent tax on payments to non-resident aliens and foreign corporations or which would be subject to such tax but for the fact that the amount is from sources outside the United States is original issue discount, is exempt from U.S. tax by a treaty or is exempt from withholding under section 1441(c).

The Act excludes from the definition of interest payments made by certain foreign persons unless the Treasury provides otherwise by regulation. Except as otherwise provided in regulations foreign payors exempt from the withholding requirements are (1) foreign governments and international organizations or any agency or instrumentality thereof, (2) foreign central banks of issue, (3) foreign corporations not engaged in a U.S. trade or business, (4) foreign corporations making payments that would be exempt from withholding (secs. 1441 and 1442) if paid to a non-U.S. person, and (5) partnerships not engaged in a U.S. trade or business and composed entirely of non-resident alien individuals, and persons described in (1), (2), and (3).

Finally, the Act provides that, unless otherwise provided by regulations, interest subject to withholding does not include any amount paid outside the United States which is foreign source income.

Original issue discount.—In general, original issue discount is taxable as interest, and is subject to withholding, to the extent includible in any holder's gross income tax during the taxable year.

In the case of original discount on evidences of indebtedness with a fixed maturity date not exceeding one year from the date of issue, no withholding is required until actual payment of that original issue discount on redemption. To the extent there are payments of coupon interest during the life of such a short-term obligation, therefore, withholding is only required with respect to the coupon interest paid.

In the case of obligations with a fixed maturity date exceeding one year from the date of issuance, withholding is required with respect to the amount of original issue discount includible in the holder's gross income during the calendar year. Under the Act, however, withholding on original issue discount is required only out of amounts of cash actually paid during the calendar year, whether interest or principal. Thus, on redemption of a long-term discount obligation, the withholding will be based only on the amount includible in the holder's income during the calendar year in which redemption occurs. The Secretary may by regulation require withholding on original issue discount obligations in the absence of cash payments if he determines that the obligations are of a type that are frequently used to avoid withholding. Any such regulations, however, may be effective only with respect to obligations issued 30 days after regulations are published in the Federal Register.

For long-term original issue discount obligations issued after December 31, 1982, the Act's requirement that such obligations must be issued in registered form will insure that the issuer, who will know the issue price of the obligations, will be in a position to determine the amount of discount includible in the holder's income. Consequently, the proper amount of withholding tax can be computed. In computing the amount of original issue discount includible in income of a long-term original issue discount obligation, subsequent holders of the obligation are treated like original holders. A premium paid on the purchase of a long-term obligation in the secondary market will be ignored for withholding purposes.

In the case of short-term discount obligations, including short-term government obligations with acquisition discount, withholding is based on the difference between the obligation's issue price and its stated redemption price at maturity. If a purchaser acquires such an obligation through a broker and arranges for the same broker to hold the obligation until maturity, the broker will have a record of the amount of discount income. As a result, the broker will be in a position to withhold the correct amount of tax from the payment at maturity. If a short-term discount obligation is acquired from one broker and redeemed through another broker, the purchaser will be able to establish his purchase price for the obligation by means of records that are generally accepted on audit to establish basis. Thus, a confirmation receipt could be used by a holder, and relied upon by the broker, to establish his purchase price for the obligation. If a purchaser is, for any reason, unable to supply information as to his purchase price, the person redeeming the instrument is required to assume that he purchased the obligation at the issue price as indicated in standard financial sources. In the case of a Treasury bill, the purchase price will be assumed to be the average noncompetitive price of the Treasury bill with the longest maturity maturing on that date. Although overwithholding may result in some cases, Congress determined this is not a serious problem because the holder will receive a credit against his total tax liability and will be entitled to obtain a refund on any overwithheld taxes. More importantly, if the holder provides the required information, he may in all cases avoid overwithholding.

Dividends.—Dividends subject to withholding are (1) any distribution of property made by a corporation to its shareholders out of accumulated or current earnings and profits (including such a distribution by a regulated investment company, other than capital gains or exempt-interest dividends); and (2) any payment made by a stockbroker to a person as a substitute for such a dividend (as, for example, in the case of a short sale).[3]

In general, the term "dividend" does not include amounts which are not periodic in character or which are not taxable. Thus, the term dividend excludes (1) any amount which is a distribution by a qualified public utility of shares of its qualified stock to an individual with respect to the common or preferred stock of such corporation, under a plan in which the shareholders may elect to receive stock as dividends instead of property (i.e., a qualified reinvestment dividend within the meaning of section 305(e)(2)(A) without regard to the limitations on the amount excluded by the payee); (2) any amount treated as a taxable dividend by reason of section 302 (relating to a redemption of stock); (3) any amount treated as a taxable dividend under the provisions of section 306 (relating to dispositions of certain stock), section 356 (relating to receipt of additional consideration in connection with certain reorganizations), or section 1081(e)(2) (relating to certain distributions pursuant to an order of the Securities and Exchange Commission); (4) any amount which is a capital gain dividend distributed by a regulated investment company, or a real estate investment trust; (5) any amount which is an exempt interest dividend of a regulated investment company; and (6) any amount paid or treated as paid by a regulated investment company during the year if, under regulations prescribed by the Secretary, it is anticipated that at least 95 percent of the dividends paid or treated as paid during such year (not including capital gains distributions) will be exempt interest dividends. In addition, the term "dividend" does not include amounts subject to withholding when paid to foreign corporations, foreign partnerships, or non-resident aliens; amounts which would be subject to such withholding but for the fact that the amounts are non-U.S. source income, the payor is excepted from the withholding requirement of section 1441(a), by section 1441(c), or the amounts are exempt from tax under a tax treaty, or such amounts are original issue discount; payments to foreign government or international organizations, exempt from tax under section 892 or, to the extent provided in regulations, amounts paid by a foreign corporations not engaged in a U.S. trade or business.

---

[3] The Subchapter S Revision Act of 1982, Public Law 97-354, is effective for taxable years beginning after 1982. Distributions by a subchapter S corporation under the rules of that Act are not dividends. However, distributions by a subchapter S corporation out of earnings and profits which arose either under prior law or while the corporation was subject to the rules of subchapter C are dividends subject to withholding.

If the withholding agent is unable to determine the portion of a distribution which is a dividend, such withholding agent must withhold from the gross amount of the distribution as if it were entirely a dividend.

Patronage dividends.—For withholding purposes, a patronage dividend is the amount of any patronage dividend which is paid by a cooperative in money, qualified written notices of allocation, or other property (except nonqualified written notices of allocation). In the case of an exempt farmer's cooperative, the term patronage dividend includes any amount paid in money, qualified written notices of allocation or other property (except nonqualified written notices of allocation) to patrons on a patronage basis with respect to earnings during the taxable year derived from business done for the United States or any of its agencies, or from nonpatronage sources. Amounts paid in redemption of either type of nonqualified written notice of allocation described above are also subject to withholding.

The term "patronage dividend" does not include any amount which is subject to withholding on amounts paid to nonresident alien individuals, foreign partnerships, or foreign corporations; or any amount which would be subject to such withholding but for the fact that such amount is attributable to income from sources outside the United States or the payor is excepted from withholding by statute or by tax treaty; or any amount paid by a foreign corporation not engaged in a trade or business in the United States.

In determining the amount of any patronage dividend subject to withholding, property (other than nonqualified written notices of allocation) is taken into account at its fair market value, and qualified written notices of allocation must be taken into account at their stated dollar amounts. However, the amount of a patronage dividend, a part of which is a qualified written notice of allocation described in section 1388(c)(1)(B), is taken into account only if 50 percent or more of the patronage dividend is paid in money or by qualified check. The Secretary is provided with authority to determine under which conditions the withholding obligation imposed by this provision may be paid from an account or source other than from the payment which gives rise to the liability for tax.

Per-unit retain allocations are not subject to withholding. For this purpose, a per-unit retain allocation is any allocation by a cooperative to a patron, with respect to products marketed for him, the amount of which is fixed without reference to the net earnings of the organization pursuant to an agreement between the organization and patron. Unlike a qualified written notice of allocation, there is no requirement under the Code that a qualified per-unit retain allocation be paid at least 20 percent by qualified check. Therefore, there may be no actual distribution out of which withholding can be taken.

Information returns of withheld tax

Information returns with respect to payments of interest, dividends and patronage dividends subject to withholding must be made under the information reporting provisions of prior law, as amended. In particular, information reporting is required on any payment from which an amount is withheld, even if the payment does not exceed the otherwise applicable $10 minimum for reporting purposes. Similarly, the payor is required to mail a statement to the payment recipient showing the total amount paid and amount withheld. To the extent the Secretary determines that attachment of such statement to the taxpayer's income tax return for the taxable year would aid in the administration of the tax laws, he may require that such statements be filed with such returns.

Failure to comply with these information reporting requirements is subject to the $50 penalty provided by the Act (increased from $10 in prior law), and the increased penalty for intentional disregard of the filing requirements. Similarly, failure to file information statements with recipients also is subject to a $50 penalty.

Effective Date

This provision applies to payments made after June 30, 1983.

2. Improved Information Reporting

a. Reporting of interest (sec. 309 of the Act and sec. 6049 of the Code)[*]

Prior Law

Reporting requirements

Every person who makes payments of interest aggregating $10 or more to any other person during the calendar year, or who receives payments of interest as a nominee and who then makes payments of interest aggregating $10 or more in any calendar year to any other person with respect to the interest so received, must file an information return with the Internal Revenue Service. Such information return must be filed with the Internal Revenue Service after September 30 (but not before the payor's final payment for the year), and on or before February 28 of the following year. These returns must set forth the aggregate amount of interest payments to the taxpayer and the taxpayer's name and address.

In addition, any corporation that had outstanding an obligation in registered form with respect to which $10 or more of original issue discount was includible in the gross income of any holder during any calendar year was required to file an information return with the Secretary. This return was required to report the aggregate amount includible in income by each holder of the discount obligation during the calendar year, the ratable monthly portion of the original issue discount, the issue price of the obligation, and the stated redemption price at maturity. These original issue discount information returns were required to be filed with the Internal Revenue Service after December 31 of the calendar year of accrual and on or before February 28 of the following year.

Payors of interest and persons who are required to file information returns with respect to original issue discount must also furnish information statements to recipients setting forth the aggregate amount of interest payments or original issue discount includible in income. Statements to recipients of interest must be furnished after November 30 (but not before the final interest payment for the year) of the calendar year and on or before January 31 of the following year. These statements may be furnished at any time after April 30 of the calendar year of payment if furnished with the final interest payment for the calendar year. Statements with respect to original issue discount must be furnished after December 31 and on or before January 31 of the following year.

---

[*] For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 311; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 238-241; and H. Rep. No. 97-760 (August 17, 1982), pp. 562-563 (Joint Explanatory Statement of the Committee of Conference).

Definition of interest

For reporting purposes, interest was defined as (1) interest on any evidence of indebtedness issued by a corporation in registered form; (2) interest on deposits with persons carrying on the banking business; (3) amounts paid by mutual savings banks, savings and loan associations, building and loan associations, cooperative banks, credit unions or similar organizations in respect to deposits, investment certificates or withdrawable or repurchasable shares; (4) interest on amounts held by an insurance company under an agreement to pay interest thereon; and (5) interest on deposits with stockbrokers and securities dealers. In addition, under prior law, the Secretary had regulatory authority (which was not used) to provide that interest included interest on evidences of indebtedness issued in other than registered form by a corporation of a type offered by corporations to the public.

The term interest did not include interest on State or local government obligations exempt from tax under the Internal Revenue Code; interest on amounts paid by or to a foreign corporation, nonresident alien, or partnership composed in whole or in part of nonresident aliens not engaged in a U.S. trade or business, to the extent excluded from the definition of interest by regulation; and any amount paid with respect to a tax-free covenant bond where the person making the payment was required to deduct and withhold the tax, or would have been so required but for any personal exemption claimed by the payee.

Reasons for Change

Congress believed that the information reporting system with respect to the payment of interest should be conformed to the new interest withholding rules adopted as part of the Act so that all payments of interest subject to withholding would also be subject to the information reporting rules. An improved information reporting provision will assure that payments subject to withholding will be properly reported. An expanded system of information reporting, which also entitles persons to notice of the amount of interest paid to them without regard to whether such amounts were subject to withholding, will assure that compliance is achieved on payments subject to these exceptions.

Explanation of Provision

Reporting requirement

Under the Act, every person making a payment of interest, including deemed payments of original issue discount is required to report the payment if the payment is subject to withholding or aggregates $10 or more in the calander year. Any person making any other payment of interest, including interest received as a nominee, aggregating $10 or more to any other person during the calendar year, must file an information return with the Secretary setting forth the aggregate amount of such payments, the amounts, withheld, if any, and the name and address of the person to whom paid or from whom withheld. Under the Act, as under prior law, original issue discount is treated as paid at the time includible in income, without regard (in the case of a long-term obligation) to any reduction in the amount of original issue discount actually includible in income which results from a purchase of the obligation at a price in excess of the issue price plus accrued original issue discount. In the case of original issue discount on a bearer obligation issued before January 1, 1983, and original issue discount which is not includible in the income of a holder periodically (because, for example, the obligation has a maturity of one year or less), the original issue discount is treated as paid on the earlier of redemption or maturity of the obligation. Similarly, acquisition discount on short-term government obligations (which is also treated as interest for tax purposes) is treated as paid at the earlier of redemption or maturity of the obligation. Under these rules, the amounts reported with respect to payees of original issue discount could be different from the amount, in fact, includible in the payee's income. The payor could indicate this fact to the payee.

Definition of reportable interest

Under the Act, the definition of interest for information reporting purposes generally is conformed with the definition of interest for interest withholding purposes. Thus, interest for reporting purposes includes any interest subject to withholding (including original issue discount). As a result of the exception for short-term obligations held by corporations, interest paid on most commercial paper is not subject to this reporting provision. More precisely, reportable interest includes (1) interest on any obligation (other than any obligation with a maturity at issue of not more than 1 year which is held by a corporation) which is issued in registered form, or which is of a type offered to the public; (2) interest on deposits with persons carrying on the banking business; (3) amounts (whether or not designated as interest) paid by a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, industrial loan association or bank, or similar organization, in respect to deposits, investment certificates, or withdrawable or repurchasable shares; (4) interest on amounts held by an insurance company under an agreement to pay interest thereon; (5) interest on deposits with brokers as defined in section 6045(c); (6) interest paid on amounts held by investment companies and on amounts invested in other pooled funds or trusts; and (7) to the extent provided in regulations prescribed by the Secretary, any other interest (which is not specifically excluded from the definition of interest). These are generally the same categories of interest that were subject to reporting under prior law except that interest on all obligations (in registered form or of a type offered to the public) is subject to reporting in contrast to interest on only corporate registered obligations as under prior law.

The Act does not alter the administration rule under prior law that interest on bearer obligations paid outside the United States by a United States person (*e.g.*, a foreign branch of a U.S. bank) acting as a paying agent for a foreign corporate issuer (or for a U.S. corporate issuer whose interest payments are foreign-source) is exempt from the information reporting requirements. Congress did not intend that the Secretary change his existing regulations to require reporting on such payments; however, as under prior law applicable to information reporting, the Secretary continues to be empowered to require information reporting on such payments.

Interest subject to reporting does not include interest on obligations issued by natural persons; interest on exempt governmental obligations; and, except to the extent otherwise provided in regulations, any amount paid to a person who qualifies as an exempt recipient for purposes of the withholding provision (other than a nominee or custodian, financial institution, broker, or other person specified in regulations as a middleman between the payor and payee) if that person had a valid exemption certificate on file or is described in regulations prescribed by the Secretary which permit exemption from withholding without certification.

Thus, interest on obligations described in section 103 will generally not be subject to information reporting. In determining whether an obligation is exempt from tax, under section 103, middlemen such as financial institutions have no duty to inquire beyond the information contained in the obligation.

Interest does not include any amount subject to withholding with respect to payments made to nonresident aliens, foreign partnerships, and foreign corporations, or which would be subject to such withholding requirement except for the fact that such amount is income from sources outside the United States, the payor is excepted from the withholding requirement of section 1441(a) by section 1441(c), the amount is exempt from tax under a tax treaty, or the amount is original issue discount.

Finally, interest does not include, except to the extent otherwise provided in regulations, any amount which is non-U.S. source income or which is paid by a foreign government or international organization (or any agency or instrumentality thereof), a foreign central bank of issue, a foreign corporation not engaged in a U.S. trade or business, a foreign corporation making interest payments to a U.S. person which interest payments are foreign source (or which would be exempt from withholding under section 1441 if made to a foreign person), or a partnership not engaged in a U.S. trade or business and composed in whole of nonresident alien individuals, foreign governments, international organizations (or any agency or instrumentality thereof), foreign central banks of issue, or foreign corporations, etc., not engaged in a U.S. trade or business. (Thus, the Act repeals the regulatory authority of the Secretary under prior law to except payments of interest by certain partnerships composed in part of persons other than nonresident aliens.) However, if interest described in this paragraph is paid to, or is collected on behalf of, a U.S. person within the United States by another U.S. person acting as a collection agent or other middleman, such interest is not exempt from reporting under the Act.

The Act also provides that any financial institution, broker, or other person specified in regulations, acting as a middleman between the payor and the payee of interest (as a nominee or otherwise) may, under regulations, be required to file information returns and statements. Such reports would be in lieu of reporting by any other person with respect to such interest. Thus, if the regulations prescribed by the Secretary so provide, each person in the chain of payments between the payor and the ultimate payee need not file an information return or statement with respect to the same payment when regulations require one person in the chain is required to discharge the reporting obligations of all persons in the chain. For example, if a bank collects an interest coupon and makes a payment thereon on behalf of the issuer, the regulations may require that the bank file the information return and statement and may relieve the issuer of any obligation to file an information return.

The Secretary also is given regulatory authority to provide for reporting payments of interest by financial institutions, brokers and other middlemen on transactional, rather than annual, aggregate basis. Under transactional reporting, the person reporting is obligated to report with respect to each transaction in which $10 or more of interest is paid or in which tax is withheld, rather than waiting until the end of the calendar year and reporting all transactions in the aggregate. A transaction is the payment at the same time of one or more obligations. For example, if a taxpayer presented five savings bonds each earning $3 of interest at one time, an information report would be required. However, if only three of the bonds were presented no report would be required (assuming the payee is exempt from withholding) even if the remaining two bonds were redeemed the following day.

As under prior law, statements must be furnished to persons with respect to whom information returns are filed with the Secretary. Such statements must be furnished on or before January 31 of the calendar year following the year of payment. However, if transactional reporting is allowed, information statements must be filed with the payee, under regulations, during January of the year following the calendar year of payment, or credit.

Effective Date

This provision is effective for amounts paid, or treated as paid, after December 31, 1982.

b. Obligations required to be registered (sec. 310 of the Act and secs. 103, 163, and 312 of the Code and new sec. 28 of the Second Liberty Bond Act)*

Prior Law

Under prior law, the tax status of debt obligations was generally the same regardless of whether the obligation was issued in registered form or in bearer form. However, in the case of certain State and local obligations relating to housing or energy programs, interest on the obligations was exempt from Federal income tax only if the obligations were issued in registered form.

Under prior law, an obligation was in registered form only if it was registered as to both principal and interest and if its transfer could be effected only by the surrender of the old instrument and either the reissuance of that instrument by the issuer to the transferee, or the issuance of a new instrument by the issuer to the transferee. Unregistered (bearer) obligations may be transferred by delivery of the instrument to the purchaser.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 312; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 242-244; and H. Rep. No. 97-760 (August 17, 1982), pp. 563-565 (Joint Explanatory Statement of the Committee of Conference).

Also, see H.R. 6056, Technical Corrections Act of 1982; House floor amendents, 128 Cong. Rec. H9600-9604; H. Rep. 97-986 (Dec. 21, 1982), p. 19 (Joint Explanatory Statement of the Committee of Conference).

Reasons for Change

Congress believed that a fair and efficient system of information reporting and withholding could not be achieved with respect to interest-bearing obligations as long as a significant volume of unregistered long-term instruments were being issued. Congress decided that a system of book-entry registration would preserve the liquidity of obligations while requiring the creation of ownership records that could produce useful information reports with respect to both the payment of interest and the sale of obligations prior to maturity through brokers. Further, Congress decided that a system of registration would reduce the ability of noncomplying taxpayers to conceal income and property from the reach of the income, estate, and gift taxes. Finally, Congress decided that a registration requirement could reduce the volume of readily negotiable substitutes for cash available to persons engaged in illegal activities.

Congress also recognized the importance of preserving liquidity in the financial markets. Thus, a flexible book-entry system of registration was permitted and exceptions from the registration requirements were provided for short-term obligations, for obligations of a type not offered to the public and for certain obligations issued abroad.

Explanation of Provision

Overview

The Act restricts the issuance of long-term bearer obligations by imposing a direct prohibition on the issuance of long-term bearer obligations by the United States and its agencies or instrumentalities and by denying certain tax benefits to issuers and holders of other bearer obligations issued after 1982. In addition, an excise tax is imposed on bearer obligations that are registration-required obligations not issued in registered form (other than obligations the interest on which is exempt from tax if issued in registered form). No sanction can be imposed, however, on the issuance in bearer form of (1) obligations of a natural person, (2) obligations with a maturity at issue of not more than one year, (3) obligations of a type not offered to the public and (4) certain obligations designed for issuance to persons who are not U.S. persons.

Obligations of the United States

The Act amends the Second Liberty Bond Act (31 U.S.C. 757c–5) to require that every "registration-required obligation" issued by the United States or any agency or instrumentality thereof (a U.S. obligation) must be in registered form. For this purpose, registration-required U.S. obligations are any obligations other than obligations of a type not offered to the public or with a maturity at issue of not more than one year or certain obligations issued abroad.

An obligation will be treated as issued in registered form if the right to the principal of, and interest on, the obligation may be transferred only through a book entry system consistent with regulations prescribed by the Treasury. An obligation will also be considered issued in registered form if its transfer may be accomplished only by means of reissuance by the issuer of the old obligation to the new holder, or by issuance of a new obligation to the new holder. It was anticipated that a book-entry system similar to that used with respect to Treasury bills would constitute a proper registration system. When necessary, the Secretary may provide for maintenance of such book entries by an agent of the issuer or through a chain of one or more nominees, so long as such a system of book entries provides an audit-trail through which the Commissioner could determine the ultimate owner of the interest or principal of any obligation at any particular time.

An exception from the otherwise applicable registration requirement is provided for obligations of the United States if there are arrangements reasonably designed to insure (1) that the obligation will be sold (or resold in connection with its issuance) only to persons who are not United States persons (as defined in section 7701(a)(30)), (2) if issued in bearer form, the interest on the obligation is payable only outside the United States or its possessions, and (3) if issued in bearer form, a statement on the face of the obligation indicates that any U.S. person who holds the obligation will be subject to limitations under U.S. income tax laws.

Other obligations

Under the act, obligations issued by persons other than the United States and its agencies and instrumentalities generally must be issued in registered form in order to avoid the imposition of certain sanctions. For this purpose, registration-required obligations are obligations of a State or local government or any other issuer other than a natural person, except (1) obligations issued by a natural person, (2) obligations not of a type offered to the public, and (3) obligations with a maturity at issuance of not more than one year. An exception from the otherwise applicable registration requirement is also provided for obligations designed for issuance to persons who are not U.S. persons, if (1) there are arrangements reasonably designed to insure that the obligation will be sold (or resold in connection with its issuance) only to persons who are not United States persons (as defined in section 7701), (2) if issued in bearer form, the interest on the obligation is payable only outside the United States or its possessions, and (3) a statement on the face of the obligation indicates that any U.S. person who holds the obligation will be subject to limitations under U.S. income tax laws.

The Secretary is given authority to require registration of short-term, non-public obligations and those obligations designed to foreign markets if, with respect to specific types of obligations, he determines that such obligations are used frequently to avoid Federal taxes. Such a registration requirement would be for obligations issued after the date final regulations requiring registration are in effect.

The determination of whether an obligation is not of a type offered to the public is a factual one. The issue is not whether the particular obligation is one offered to the public, but rather whether obligations of that type are offered to the public.

Sanctions against issuance of bearer obligations

If a registration-required obligation is not issued in registered form, then one or more of issuer or holder sanctions may apply.

With respect to the issuer, no interest deduction is allowable for the issuer with respect to interest (including original issue discount) paid or accrued on the obligation. In addition, the earnings and profits of a corporation (other than certain foreign corporations) issuing a registration-required-obligation in bearer form are not reduced by the amount of any interest (including original issue discount) paid or accrued on the obligation. Moreover, if interest on an unregistered registration-required-obligation would otherwise be exempt from tax under the Code or any other provision of law (for example, certain State and local obligations), the exemption from tax will not apply. However, this rule does not override any treaty provision exempting interest from taxation by the United States. Finally, the Act imposes an excise tax on the issuer of a registration-required obligation in bearer form, equal to one percent of the principal amount of the obligation multiplied by the number of calendar years, or portions thereof, from the date of issuance to the date of maturity of the obligation. For this purpose, the term registration-required means any obligation, and other than (1) an obligation issued by a natural person, (2) an obligation not of a type offered to the public, (3) a short-term obligation, and (4) certain obligations designed for foreign markets. The excise tax does not apply, however, to the issuance of obligations the interest on which would be exempt from tax if the obligation were in registered form.

The holder sanctions are imposed on U.S. persons who own bonds issued after 1982, and that were registration-required but were issued in bearer form. However, if the issuance of the obligation was subject to the excise tax, then the holder sanctions do not apply. Specifically, these sanctions are the loss of capital gains treatment and the denial of loss deductions when such obligations are sold, exchanged, stolen, lost, etc., or become worthless. The holder sanctions apply to bonds intended to be distributed outside the United States and which are excepted from the issuer sanctions, unless such bonds are owned in registered form. The Secretary may, by regulations, provide exceptions from the holder sanctions for persons who promptly surrender bearer obligations for reissuance in registered form, for persons who hold certain bearer obligations in connection with their active conduct of a trade or business outside the United States, for registered broker dealers holding bearer bonds in inventory, and for persons complying with reporting requirements that may be promulgated by the Secretary. However, such exceptions may not apply unless the obligations are held under arrangements (provided in regulations or otherwise) which are designed to assure that such obligations are not delivered to any United States person other than the persons described in the foregoing sentence who hold the obligations in connection with a trade or business outside the United States, who are registered broker dealers holding obligations as inventory, or who comply with prescribed reporting provisions.

BEST COPY AVAILABLE

Definition of registered form

For purposes of these new rules, a book-entry obligation is in registered form if the right to principal and interest is transferable only through a book entry consistent with regulations issued by the Secretary. This book entry requirement will be satisfied by entries, consistent with regulations issued by the Secretary, that permit the ultimate beneficial owner of the obligation and its interest to be identified by way of the system. Thus, if an obligation is issued in a street name to one person who then holds that obligation for another, the registration requirement will be satisfied by entries in the books of the holder. It was anticipated that a system of book entries comparable to that used with respect to Treasury bills would satisfy the registration requirement. In addition, a small issuer could use an agent to maintain its book-entry system. If local law required the issuer to maintain its own registry, the issuer could, of course, issue a single registered obligation to its agent who could then re-issue the obligation, including the use of participations in a jumbo or master obligation, in such a form that the ultimate beneficial owners can be identified. Finally, it was anticipated that the Secretary would require that such book-entry systems be maintained in a manner that would permit examination of the entries by the Secretary in connection with enforcement of the internal revenue laws.

Effective Date

These new registration requirements, and the associated sanctions for issuance of registration-required obligations in bearer form, will apply to obligations issued after December 31, 1982. The holder and issuer sanctions applicable to registration-required obligations issued in bearer form after 1982 do not apply to obligations issued in bearer form after December 31, 1982, pursuant to warrants or upon conversion of convertible obligations, issued before August 10, 1982, provided the warrants or convertible obligations were offered or sold outside the United States without registration with the SEC, and issued before August 10, 1982. Long-term U.S. obligations must be registered if issued after September 4, 1982.

An obligation, the terms of which are fixed and for which full consideration is received on or before December 31, 1982, is not registration-required even if smaller denomination certificates in that identical obligation are not distributed to ultimate investers until after that date.

The Technical Corrections Act of 1982 subsequently provided that, in the case of obligations the interest on which is exempt from taxation under section 103 or any other provision of law (without regard to the identity of the holder), the amendments relating to registration of obligations will not apply to obligations issued before July 1, 1983.

c. Returns of brokers (sec. 311 of the Act and sec. 6045 of the Code)*

Prior Law

Under prior law, every person doing business as a broker had to make a return, when required under regulations issued by the Secretary, showing customers' names and such details regarding profits and losses, and such further information, as the Secretary required. There were, however, no regulations in effect under this section. Brokers, therefore, did not have an obligation to report transactions of customers. Under both prior and present law, special rules apply to the summons of records held by third-party recordkeepers.

Reasons for Change

A preliminary Internal Revenue Service estimate for 1981 indicated that the compliance rate for capital gains reporting was below 60 percent. Congress determined that compliance in this area could be substantially improved by requiring that transactions carried out through brokers and other middlemen be reported to the Internal Revenue Service. At the same time, Congress recognized the need to balance carefully the cost of reporting by brokers against the incremental improvement in compliance.

In addition, Congress believed that barter exchanges should be treated as brokers for purposes of this reporting requirement, and the third-party summons rules.

Explanation of Provision

The Act modifies the prior law rules relating to reporting by brokers in three respects. First, the Act permits the Secretary to require reporting of gross proceeds from transactions carried on by brokers for their customers in addition to, or in lieu of, details of profit and loss and such other information as the Secretary may require. Second, the Act requires persons making returns to the Internal Revenue Service as brokers to furnish statements of the information filed with the Internal Revenue Service to their customers on or before January 31 of the year following the calendar year for which the broker return is made. Third, the Act clarifies the term broker to include persons such as dealers, barter exchanges, and others who (for consideration) regularly act as middlemen with respect to property or services. For this purpose, a barter exchange is any organization of members providing property or services who jointly contract to trade or barter such property or services. The term broker does not include persons, such as wholesalers, who act for their own account or informal non-business exchanges of identical services, such as baby-sitting cooperatives or car-pools.

Brokers in securities and commodities are subject to the broker reporting requirement whether the sales effectuated for a customer were sales between the customer and a third party in which the broker acted as an agent or transactions between the broker and the customer in which the broker acted as a principal for its own account.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 313; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 245-246; and H. Rep. No. 97-760 (August 17, 1982), pp. 565 (Joint Explanatory Statement of the Committee of Conference).

The Act specifically requires that regulations governing securities and commodity brokers under the amended broker reporting provisions be issued within six months after the date of enactment. These regulations may apply to transactions occurring after December 31, 1982. In prescribing such regulations, Congress expected that the Secretary would take into account industry practices in designing an efficient and workable system of reporting that is consistent with his statutory obligation to improve compliance with respect to the reporting of capital gains and other taxable transactions effected through brokers. In particular, to the extent practicable, the reporting system should be conformed to industry practices in maintaining brokerage activity records and should minimize broker data processing and storage costs. The Act gives the Secretary broad latitude in determining what information is appropriate and useful for reporting by brokers to the Internal Revenue Service and for furnishing information statements to the customers of brokers. For example, the Secretary could require reporting, on the basis of individual transactions, not only of gross proceeds of sale transactions but also concerning purchase transactions. In addition, the Secretary need not require reporting or transactions such as redemptions of money market shares or transactions carried out on behalf of other brokers or financial institutions.

The Act also extends the definition of third-party recordkeepers to include barter exchanges which are subject to the information reporting requirements imposed on brokers (see secs. 331 and 332 of the Act). In the case of third-party summonses, therefore, such barter exchanges are subject to all the various rules applicable to other third-party recordkeepers.

Effective Date

This provision became effective on September 4, 1982, except that the provision defining barter exchanges as third-party recordkeepers is effective for summonses served after December 31, 1982. Further, regulations relating to reports by commodities and securities brokers must be issued under this provision within 6 months after September 4, 1982; however, any such regulations may not apply to transactions occurring before January 1, 1983.

d. Information reporting requirements for payments of remuneration for services and direct sales (sec. 312 of the Act and new sec. 6041A of the Code)*

Prior Law

Under prior law and present law, any person engaged in a trade or business generally must file an information return (Form 1099) with respect to payments to another person aggregating $600 or more in the calendar year (sec. 6041(a)). This reporting obligation, subject to various exceptions, applies to payments (whether made in cash or property) of salaries, wages, commissions, fees, other forms of compensation for services, and other fixed or determinable gains, profits, or income. Payments made to corporations are exempt from this reporting obligation under existing Treasury regulations.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 314; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 247-249; Senate floor amendments, 128 Cong. Rec. S. 8971 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 565-567) (Joint Explanatory Statement of the Committee of Conference).

These information returns, which must be filed on an annual basis, generally must contain the name, address, and identification number of the recipient of the payments and the aggregate amount paid (secs. 6041(a) and 6109(a)). Recipients covered by this reporting requirement must furnish their names and addresses to the payor (sec. 6041(c)).

In addition, a payor required to file such an information return with the Internal Revenue Service also must provide the recipient with a statement which shows the information reported to the Internal Revenue Service (sec. 6041(d), effective for returns required after 1981).

Prior law did not contain specific information reporting requirements relating to direct sales of consumer products.

Reasons for Change

Congress believed that improvements in the information reporting provisions will increase the Internal Revenue Service's ability to administer and enforce the tax laws and will improve taxpayer compliance with the income and employment taxes. In addition, Congress concluded that applying information reporting requirements with respect to certain direct sales of consumer goods will facilitate enforcement and compliance without placing undue burdens on direct sellers.

Explanation of Provision

Payments of remuneration

The Act adds a separate provision (new Code sec. 6041A) specifically dealing with payments of remuneration for services.

Under this provision, a service-recipient (*i.e.*, a person for whom services are performed) engaged in a trade or business who makes payments of remuneration in the course of that trade or business to any person for services performed must file with the Internal Revenue Service an information return reporting such payments (and the name, address, and identification number of the recipient) if the remuneration paid to the person during the calendar year is $600 or more. Also, the service-recipient must furnish to the person receiving such payments a statement setting forth the name, address, and identification number of the service-recipient, and the aggregate amount of payments made to the payee during the year.

Direct sales

General requirements

The Act also imposes a new information reporting requirement for certain direct sellers. This requirement applies to any person engaged in a trade or business who in the course of such trade or business sells consumer products on a buy-sell basis, deposit-commission basis, or any similar basis specified in Treasury regulations[1] to any buyer who is engaged in either (1) selling such products in a home or otherwise than in a permanent retail establishment, or (2) selling those products to other persons so engaged.

Reporting on gross purchases for resale

A direct selling business will be required to report with respect to gross purchases of consumer products for resale by any buyer purchasing $5,000 or more of such products in a calendar year. In addition, the business will be required to report commissions and other remuneration under the reporting provisions generally applicable to such payments.

Under the new requirement, the seller must file a return setting forth the name, address, and identification number of the buyer. The seller also must furnish the buyer with a statement setting forth the name, address, and identification number of the seller. The fact that a buyer purchases some of the products for personal use or consumption, rather than for resale, has no effect on the applicability of the reporting requirement. However, purchases of goods that cannot be resold, such as catalogues and samples, need not be reported.

Interim period for regulatory exceptions

Because the Act creates a new statutory provision regarding payments of compensation for services, the regulatory exceptions applicable to the prior statutory reporting requirements for such payments (e.g., payments to corporations) will not automatically apply. Congress believed it would be inappropriate to impose penalties for any failure to comply with reporting requirements that are subject to specific regulatory exceptions under prior law until new regulations are issued and businesses are afforded an appropriate period of time to comply with any new requirements. This grace period should in no event extend, however, to payments made after December 31, 1983.

Effective date

The provision applies to payments and sales made after December 31, 1982.

---

[1] A transaction is on a buy-sell basis if the buyer is entitled to retain the difference between the price at which he or she purchased the product and the price at which the product is sold as part or all of the buyer's remuneration for reselling the seller's products. A transaction is on a deposit-commission basis if the buyer is entitled to retain a purchase deposit paid by the consumer as part or all of his or her remuneration.

e. Reporting of State and local income tax refunds (sec. 313 of the Act and new sec. 6050E of the Code)*

Prior Law

The refund, credit or offset of State or local income taxes that were deducted (with a resulting tax benefit) in a prior year is includible in gross income.

Under prior law, there was no requirement that information returns with respect to such refunds be filed with the United States or that refund recipients receive information statements with respect to such refunds during the tax-filing season. Twelve States, however, provided such information to the Internal Revenue Service under voluntary information exchange agreements.

Reasons for Change

Congress believed that requiring information reporting on State and local income tax refunds, including reporting to individual taxpayers, will remind taxpayers of the proper treatment of such refunds and provide them with helpful information during the tax-filing season.

Explanation of Provision

The Act provides that an information return must be filed with the Secretary with respect to any State or local income tax refunds, credits, or offsets aggregating $10 or more during the calendar year paid or credited to an individual. These reports are required when amounts are paid over or credited regardless of whether they are taxable to the taxpayer in that taxable year. Thus, an amount paid over or credited is reportable even though it is not taxable because the taxpayer received no tax benefit. Similarly, if an amount is credited to reduce the future liability of the taxpayer, it is reportable once credited even though the liability against which the credit will be taken has not yet arisen. The return required by this provision must report the aggregate amount of any such refund payments, credits, or offsets, and the recipient's name and address. State and local governments can satisfy their return obligations under this provision through voluntary information exchange agreements (such as those now currently in effect between the United States and 12 States).

In addition, the provision requires that a statement with respect to each return be furnished to the recipient of the refund, credit or offset during January of the calendar year following the calendar year in which the refund is made or the credit or offset allowed.

Effective Date

This new requirement will apply to refunds paid, and credits or offsets allowed, after December 31, 1982.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 315; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), p. 250; Senate floor amendments, 128 Cong. Rec. S9013 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 567-568 (Joint Explanatory Statement of the Committee of Conference).

f. Employer reporting with respect to tips (sec. 314 of the Act and sec. 6053 of the Code)*

Prior Law

Any employee who receives, in any calendar month and during the course of his employment, any tips which are wages or compensation, must report all such tips to his employer on or before the 10th day following the month of receipt. Tips are defined as wages or compensation if they are paid in cash during any calendar month, are $20 or more in amount, and are received by an employee in the course of his employment. Such wages are deemed paid at the time a written statement including such tips is furnished to the employer by the employee, or, if no statement including such tips is furnished, at the time received.

In general, withholding for purposes of the Federal Insurance Contributions Act (FICA) tax and the income tax is required only to the extent tips are reported to the employer and only to the extent collection of the tax can be made by the employer from wages paid to the employee (excluding tips, but including funds turned over by the employee to the employer or under the control of the employer). Generally, if the FICA and income tax withholding obligations exceed the amount of wages and other amounts turned over to the employer, the excess must be paid by the employee. The employer must furnish a written statement to his employees showing the amount of such excess.

Substantial recordkeeping requirements are imposed upon tipped employees and employers. In general, employees, whether or not they receive tips, are required to keep records to establish the amount of their gross income and deductions. Because tips are includible in income, employees must keep records of all tips received and of all deductible tips paid to other employees. Employers are expressly required to retain only charge tip receipts and statements of tips received by employees furnished by such employees. Failure to maintain such records may subject employees or employers to penalties (sec. 6653).

Reasons for Change

The compliance rate in 1981 with respect to tip income was approximately 16 percent according to preliminary estimates by the Internal Revenue Service based upon data furnished by the Bureau of Economic Analysis of the Department of Commerce. The only type of income with a lower compliance rate was illegal income which had a compliance rate of only 5 percent.

Congress believed that such a low compliance rate is fundamentally unfair to wage earners and other taxpayers with substantially higher levels of voluntary compliance. Expanded information reporting on tip income will encourage better reporting of such income by its recipients and facilitate Internal Revenue Service efforts to increase compliance in this area. At the same time, Congress recognized that improved compliance rules should not impose unnecessary recordkeeping obligations on taxpayers or employers.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 316; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 251-253; Senate floor amendments, 128 Cong. Rec. S. 8988 (employee allocations), S8988-S8991 (deleting provisions relating to employee tips), S. 9015 (deduction of business meals) (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 556-558 (Joint Explanatory Statement of the Committee of Conference).

Explanation of Provision

Under the Act, the rules of prior law relating to reporting of tips to employers by their employees and to the resulting withholding of FICA and income taxes are retained. However, to assist the Internal Revenue Service in its examinations of returns filed by tipped employees, the Act provides a new set of information reporting requirements for large food or beverage establishments, including, under certain circumstances, a tip allocation requirement.

Under the Act, each large food or beverage establishment is required to report annually to the Internal Revenue Service (1) the gross receipts of the establishment from food or beverage sales (other than receipts from carryout sales and mandatory 10-percent or greater service charge sales), (2) the amount of aggregate charge receipts (other than receipts from carryout sales and 10-percent or greater service charge sales), (3) the aggregate amount of tips shown on such charge receipts and (4) reported tip income together with mandatory service charges of less than 10 percent. Tips on meals charged on house charges of restaurants also will be reported. The Treasury will prescribe regulatory rules for the treatment of tips on meals charged to a room in a hotel.

If tipped employees of large food or beverage establishments voluntarily report tips aggregating 8 percent or more of gross receipts (defined as gross receipts from the sale of food or beverages less carryout sales, less 10-percent or greater service charge sales), then no tip allocations will need to be made. However, if this 8-percent reporting threshold is not met, then the employer must allocate (as tips for reporting purposes) an amount equal to the difference between 8 percent of gross receipts and the amounts reported by employees for the year to all tipped employees pursuant to either an agreement between the employer and employees or, in the absence of such an agreement, according to regulations issued by the Secretary. The employer will have no liability to employees in connection with any dispute regarding allocations of amounts under this rule.

Regulations under this provision will provide procedures under which a particular establishment, or type of establishment, can show that its tipped employee's average tip rate is less than 8 percent (but not less than 5 percent) and, can therefore, allocate based on that lower amount in the future.

The allocation of the excess of the 8-percent amount over reported tips to employees for reporting purposes will have no effect on the FICA or income tax withholding responsibilities of the employer or on his FUTA obligations. Thus, employers will continue to withhold only on amounts reported to them by their tipped employees. Of course, the allocation also has no effect on the actual entitlement of the employer or employee to gross receipts or tip income. Similarly, this purely informational report to the Internal Revenue Service will not affect the requirements of the Fair Labor Standards Act or any collective bargaining agreement.

The 8-percent figure reflects Congress's judgment that the tip rate in establishments subject to this reporting requirement will rarely be below the 8-percent level. Thus, an employee who reports less than his allocated amount of tips must be able to substantiate his reporting position with adequate books and records (as he had to do under prior law). The Internal Revenue Service can still prove that tipped employees received a larger amount of tip income. For example, as under prior law, the Internal Revenue Service could show from charge tip rates that a particular establishment had a higher tip rate than 8 percent.

A large food or beverage establishment is any establishment (public or private) the activity of which is the provision of food or beverages for consumption on the premises, other than "fast food" of a "carry-out" nature, with respect to which tipping is customary, and the employer of which normally employed more than 10 employees on a typical business day during the preceding calendar year. The 10 employee rule is to be applied with respect to all employees of the employer, not just the employees at a single establishment. The Secretary will prescribe regulations for applying the rules of sections 52 (a) and (b) for purposes of determining the number of employees of an employer. The Secretary will prescribe regulations for the application of this 10-employee rule in the case of new businesses. "Fast-food" restaurants will not generally be subject to the new reporting requirement since tipping is not customary in such establishments. Restaurants that provide table or counter service for seated customers, and cocktail lounges with similar service, are large food or beverage establishments if the employer employs 10 or more persons. A large food or beverage establishment may be part of a larger establishment such as a hotel.

It is anticipated that the information statement concerning allocated tips will be integrated into Form W-2 now supplied by employers with respect to wages. If the employer furnishes an employee with a W-2 within 30 days after the employee terminates employment, the employer must also furnish the employee and the Internal Revenue Service with an amended Form W-2 that includes tip allocations in January of the following year.

The Act requires the Secretary of the Treasury to submit, prior to January 1, 1987, to the tax writing committees of Congress a report together with a background study on the operation of this newly enacted reporting system as applied to tips received as wages or compensation. This report should be based upon a study conducted by the IRS designed to statistical accuracy with an error of plus or minus 15 percent. The study should be representative of the foodservice industry in terms of sales, size, and, types of establishments. This study should also specifically describe the following: (1) the amount of tips actually received: (2) the amount of tips voluntarily reported to the employer by the employee; (3) the amount of tips reported to the IRS on the individual's Federal tax return; and (4) a computation of the minimum wage payments to these individuals and the portion of those wages that constituted tip income.

This study should further describe tipped individuals by job category, and should distinguish between part-time and full-time employment. The study should also describe the extent of arrangements for tip sharing and tip pooling that exist among tip earners.

The report made by the Internal Revenue Service as a result of this study should contain a cost-benefit analysis of any recommendations. This analysis should include a comparison of the cost of the then existing system of enforcement of tip earner compliance through examination and any cost or revenue increase or decrease to the government if any recommendation is adopted.

Effective Dates

The amendments made by this section apply to calendar years beginning after December 31, 1982, but the allocation rules will first apply to payroll periods ending after March 31, 1983. For the first quarter of calendar year 1983 only, large food or beverage establishments will be required to file information returns that include a list of all tipped employees including their taxpayer identification numbers, wages paid and reported tip income during the period. Employees would be put on notice that their returns would be identified for audit unless the 8-percent tip reporting is satisfied.

g. Increased penalties for failure to file information returns or to furnish statements (sec. 315 of the Act and sec. 6652 of the Code)*

Prior Law

Under present and prior law, a penalty is imposed on any person who fails to file information returns on the date prescribed (with extensions), including returns relating to (1) payments by any person engaged in a trade or business of $600 or more in any taxable year of rent, salaries, premiums, annuities, and certain other types of fixed and determinable gains, profits, and income; (2) payments of dividends aggregating $10 or more in any calendar year; (3) payments of patronage dividends aggregating $10 or more in any calendar year; (4) payments of interest aggregating $10 or more in any calendar year; (5) payments by certain fishing boat operators in any calendar year; (6) income tax withheld, or (7) payments of wages in any calendar year in the form of group-term life insurance. Under prior law, the penalty was $10 for each such failure, but the total amount of the penalties imposed for all such failures during a calendar year could not exceed $25,000. The penalty is not imposed if the failure is due to reasonable cause and not due to willful neglect.

Persons with respect to whom information returns are filed generally are entitled to a statement of the information shown on the return. Under prior law, the penalty for failure to provide these statements was $10 per failure up to $25,000 per year. Employers and plan administrators must file information returns with respect to certain deferred compensation plans. Under prior law, the penalty for failure to provide these returns was $10 for each day the failure continues up to $5,000. These penalties were not imposed if the failure were due to reasonable cause and not due to willful neglect.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 321; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 254-255; and H. Rep. No. 97-760 (August 17, 1982), p. 568 (Joint Explanatory Statement of the Committee of Conference).

Reasons for Change

Congress believed that inadequate information reporting of nonwage income was a substantial factor in the underreporting of such income by taxpayers. In many cases, persons who were required to make information reports did not do so because they considered the information returns unimportant or because the cost of their processing was more than the cost of the penalty that might be incurred for failure to comply with the filing requirements. Further, Congress believed that the prior law penalties and the way they were applied did not reflect the importance of timely filed information returns to the administration of the tax laws.

Explanation of Provision

The Act expands the category of information returns subject to the generally applicable penalty for failure to file timely information returns, raises the basic penalty amount, and creates a new minimum penalty for intentional failures.

Information returns newly subject to the penalty are (1) those information returns with respect to transactions carried out by brokers for their customers, (2) information returns with respect to direct sellers and, (3) information returns with respect to withholding. The Act increases the penalty for failure to file these and most other information returns to $50 per failure, not to exceed $50,000. The penalty for failure to provide information statements to taxpayers is also increased from $10 per statement to $50 per statement, up to $50,000 per calendar year.

The addition of these information returns to the list of information returns subject to the penalty, and the increase in the penalty for failure to file information returns and supply information statements, will encourage more complete reporting both by the payor of the amount and the recipient of the information return. The increase will prevent the inadvertent omission of income by a taxpayer who fails to receive a reminder of amounts received during the taxable year.

Finally, the penalty for failure to file information returns or statements with respect to certain deferred compensation plans (sec. 6058), and certain term, annuity, and bond purchase plans (sec. 6047) is increased to $25 per day while the failure continues, but not more than $15,000.

The Act provides that with respect to most information returns, when the failure to file such information returns is due to intentional disregard of the filing requirements, the penalty will not be less than 10 percent of the aggregate amount not properly reported and the $50,000 limitation will not apply. In the case of an information return required to be filed by a broker under section 6045, the penalty is not less than 5 percent of gross proceeds required to be reported, without regard to the $50,000 limitation. The lower percentage is intended to reflect the fact that brokers may be reporting gross proceeds from sales rather than gross income. In the case of returns relating to direct sellers, the intentional disregard penalty will be $100 for each failure to report a direct seller's name and address.

Effective Date

The provision applies to returns the due date of which (without extensions) is after December 31, 1982.

h. Increase in civil penalty on failure to supply identifying numbers (sec. 316 of the Act and sec. 6676 of the Code)*

Prior Law

Under prior law, a penalty of $5 per failure was imposed on any person who was required by regulations (1) to include his taxpayer identification number (TIN) in any return, statement, or document, (2) to furnish his TIN to another person, or (3) to include in any return or statement made with respect to another person the TIN of such other person, and who failed to comply with such requirement at the time prescribed. The penalty was not imposed if the failure was due to reasonable cause and not due to willful neglect. In practice, this penalty was rarely, if ever, imposed.

Reasons for Change

Congress believed that the amount of the penalty for failure to supply a TIN to another person, or to include another's TIN in a return when required to do so, did not properly reflect the importance of this information to an efficient system of tax collection. The absence of an accurate TIN makes it difficult and expensive for the Internal Revenue Service to verify and match the proper reporting of income on the tax return of the taxpayer concerned. Congress believed that further perfection of the matching process by increased accuracy in the reported TIN's will improve tax administration and ultimately will tend to increase taxpayer compliance in properly reporting income from all sources. Thus, Congress believed that the basic penalty for failing to furnish a TIN to another person when required to do so, or to include another's TIN in a return when required to do so, should be increased.

Explanation of Provision

The Act increases the penalty for failure to supply identifying numbers from $5 per failure to $50 per failure, except in the case of a failure by a taxpayer to include his own TIN in any return, statement, or other document, in which case the penalty remains at $5 for each such failure. In any case, the maximum penalty that can be imposed in any calendar year is $50,000.

Effective Date

The provision is effective for returns the due date for which (without regard to extensions) is after December 31, 1982.[2]

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 322; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 256-257; and H. Rep. No. 97-760 (August 17, 1982), p. 569 (Joint Explanatory Statement of the Committee of Conference).

[2] The provision is intended to apply with respect to failures first occurring after December 31, 1982.

i. Extension of withholding to certain payments where identifying number not furnished or inaccurate (sec. 317 of the Act and sec. 3402(s) of the Code)*

Prior Law

Prior law imposed a penalty of $5 per failure on any person who was required by regulations (1) to include his taxpayer identification number (TIN) in any return, statement, or document, (2) to furnish his TIN to another person, or (3) to include in any return or statement made with respect to another person the TIN of such other person, and who failed to comply with such requirement at the time prescribed. The penalty was not imposed if the failure was due to reasonable cause and not due to willful neglect. In practice, this penalty was rarely, if ever, imposed. There was no provision for withholding of tax on payments to persons who failed to provide an accurate TIN.

Reasons for Change

The absence of a correct TIN on an information return often makes it difficult and expensive for the Internal Revenue Service to match and verify the proper reporting of income on the tax return of the taxpayer concerned. The Act increases the basic penalty for failure to supply a TIN in certain cases (section 316 of the Act). In addition, Congress believed that if a taxpayer fails to supply his correct TIN to another person withholding should also be imposed to assure that taxpayers comply with the income tax laws.

Explanation of Provisions

The Act provides for withholding at the source at a rate of 15 percent if a taxpayer fails to supply a TIN or supplies an incorrect TIN to another person who must file certain types of information returns with respect to payments to the taxpayer. This withholding requirement applies to any payment of a kind, and to a payee, subject to most types of information reporting. The kinds of payments subject to this withholding requirement include: (1) payments of rents, salaries, wages, commissions, fees, or other forms of compensation for services and other fixed or determinable gains, profits, or income including payments to independent contractors (secs. 6041 and 6041A); (2) payments of dividends (sec. 6042); (3) payments of patronage dividends (sec. 6044); (4) payments of interest (sec. 6049); (5) payments of certain fishing boat operators (sec. 6050A); and (6) transactions through brokers. Withholding is not required on payments in kind of patronage dividends and by fishing boat operators. Further, this withholding will not apply to any payment on which withholding is required by any other provision of the Code.

Payments to certain payees are not subject to this withholding requirement. Generally, persons exempt from the information reporting requirement (and, therefore, generally not liable to supply a TIN), are not subject to this backup withholding requirement. Thus, this withholding will not apply to payments made to the United States or any agency or instrumentality thereof, to any State or political subdivision thereof, to any organization exempt from tax, or to any foreign government or international organization, or to any other person described in regulations, including individual retirement plans, and foreign central banks of issue. Finally, the Act requires the Secretary to provide for exemptions from the backup withholding provisions during periods in which a person is awaiting receipt of an identification number.

---

* For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 323; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 258-260; and H. Rep. No. 97-760 (August 17, 1982), pp. 569-570 (Joint Explanatory Statement of the Committee of Conference).

This new 15-percent withholding requirement applies to covered payments if the taxpayer (payee) is required under regulation to supply a TIN, but fails to supply a TIN, supplies an obviously incorrect TIN; or if the Secretary notifies the payor that the taxpayer's TIN is not correct. If no number is given or an obviously incorrect number is provided, then the withholding obligation applies immediately and continues until an apparently correct number is provided. For this purpose, an obviously incorrect number is a number which contains the wrong number of digits. If the Secretary notifies the payor that the payee's TIN is incorrect, then the withholding requirement applies to any payment on, or after, the sixteenth day following notification and continues until a new number is provided by the payee which is not obviously incorrect. If the payee has twice provided an incorrect number to the payor, then the payor must continue to withhold until the Secretary notifies the payor that the number provided by the payee is correct.

The payor is provided fifteen days in which to correct its records and stop withholding after a new number is provided (or confirmed by the Secretary) but may begin withholding after notification of an incorrect number prior to the sixteenth day following notification. These grace periods are provided to allow payors to adjust to the withholding requirement and to protect them from any possible liability for wrongful withholding in the period immediately preceding or following a period during which withholding is required.

Except in the case of payments of non-wage compensation, etc. for which information reporting is required under section 6041 (relating to information at the source generally) or section 6041A (relating to payments to independent contractors), this requirement for withholding applies without regard to the reporting thresholds provided for the information returns. Congress adopted this rule because it was understood to be more easily administrable by payors than a withholding system which applies only to payments in excess of the minimum amounts on which of the information reporting is required. For example, if a taxpayer fails to provide a TIN (as required by regulations), to the payor of an interest payment that is not subject to flat-rate withholding and which is less than $10, this backup withholding provision will apply even though no information report would be required until more than $10 were paid. In the case of payments of compensation etc., subject to reporting under sections 6041 or 6041A, backup withholding is not required unless (1) the aggregate of payments made after withholding is required and all prior payments during the calendar year equal or exceed $600, (2) the payor was required to file an information return with respect to the payee under section 6041 or section 6041A for the preceding calendar year, or (3) the payor made payments to the payee during the preceding calendar year on which backup withholding was required.

The Act also requires that if the Secretary notifies the payor that a TIN is incorrect, a copy of the notice must also be furnished to the payor for transmittal to the payee. The payor may furnish this notice by mailing it to the address of the payee shown on the return provided by the payor or, in the absence of such an address, by mailing the notice to the payee at his or her last known address.

Generally, payment of amounts subject to this new withholding provision will be treated as wages paid by an employer to an employee for the purpose of applying the various provisions, including the crediting provisions, that apply to collection of income tax at the source on wages.

Effective Date

This provision will apply to payments made after December 31, 1983.

j. Minimum penalty for extended failure to file (sec. 318 of the Act and sec. 6651 of the Code)*

Prior Law

If a taxpayer fails to file a tax return on the date prescribed (with extensions of time for filing), a penalty is imposed based on the amount of any underpayment of tax for the year. Under prior and present law, the penalty is 5 percent of the underpayment per month, or fraction thereof, while the failure continues, but not more than 25 percent of the underpayment in the aggregate. Thus, no penalty is imposed on the taxpayer if there is no underpayment for the year or if a refund is due. Likewise, no penalty is imposed if the failure is due to reasonable cause and not due to willful neglect.

Reasons for Change

Under prior law, many persons who owed small amounts of tax ignored the filing obligations imposed on them. Congress concluded that the prior law penalty which was measured as a percentage of the underpayment was ineffective in such cases and should be strengthened by addition of a minimum penalty.

Explanation of Provision

This provision of the Act adds a new minimum penalty for the extended failure to file any income tax return if there is an underpayment of tax for that taxable year. If an income tax return is not filed within 60 days of the date prescribed (with extensions), the penalty for failure to file will not be less than the lesser of the underpayment or $100. This minimum penalty is not imposed if the failure to file the return was due to reasonable cause and not due to willful neglect.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 325; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), p. 263; and H. Rep. No. 97-760 (August 17, 1982), p. 571 (Joint Explanatory Statement of the Committee of Conference).

Effective Date

The penalty applies to returns due (including extensions) after December 31, 1982.

k. Form of returns (sec. 319 of the Act and sec. 6011 of the Code)*

Prior Law

In general, under present and prior law, returns required by the tax laws generally must be made according to the forms and regulations prescribed by the Secretary. As a general rule, these returns must be in written form except that in certain cases the return may be made by filing the required information on a magnetic medium or other machine readable medium, provided that the prior consent of the Commissioner is obtained. Under prior law, there was no statutory or regulatory requirement that any particular return be filed on magnetic media or in other machine-readable form. Under prior law, the Internal Revenue Service was not successful in arguing that a statement of income, deductions and tax liability presented in irregular form but containing all the necessary information to compute the tax did not constitute a "return."

Reasons for Change

An essential part of any plan to improve compliance is improving the Internal Revenue Service's ability to quickly and accurately process and cross-match the information it receives. Such processing and cross-matching can be expedited and processing costs substantially reduced if returns and other information filed with the Internal Revenue Service are filed: (1) in processible form, and (2) in machine-readable form. The Internal Revenue Service will have increased capability in the future to process returns filed in machine-readable form. In addition, filings of irregular compilations of tax materials impede orderly tax administration. Congress understood that in the most recent year for which statistics were available, 14,500 persons filed 200 or more information returns each on paper, thus adding over 2,900,000 paper documents to the Internal Revenue Service's document processing burden.

Explanation of Provision

The Act requires that the Secretary prescribe regulations providing standards for determining which returns, must be filed on magnetic media or other machine-readable form. In providing these standards, the Secretary is directed to take into account, among all other relevant factors, the ability of the taxpayer to comply, at a reasonable cost, with such a filing requirement.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 326; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 264-265; and H. Rep. No. 97-760 (August 17, 1982), pp. 571-572 (Joint Explanatory Statement of the Committee of Conference).

Under this authority, for example, the Secretary could require persons filing multiple information returns (such as wage statements or interest information returns) to file such returns on magnetic media or other machine-readable form, when the basic data from which the returns are generated is already maintained in a computer. This could be appropriate even though statements for the payee and the State or local government must be printed by the computer. Similarly, the Secretary could require use of the paper forms that could be subject to optical character scanning for returns of tax by any person. In addition, the Secretary could impose a general requirement for use of magnetic media in certain circumstances but provide a mechanism for case-by-case exemptions from the requirement. The regulations issued by the Secretary under this provision may not prohibit the filing of income tax returns by individuals, trusts, or estates on paper forms provided by the Secretary.

Effective Date

This provision became effective upon enactment.

3. Other Penalty Provisions

a. Penalty for promoting abusive tax shelters, etc. (sec. 320 of the Act and new sec. 6700 of the Code)*

Prior Law

Prior law contained no penalty provision specifically directed at promoters of abusive tax shelters and other abusive tax avoidance schemes. However, when a promoter organized or sold a tax shelter that was premised on misrepresentations of the tax law, misrepresentations with respect to the existence of the investment assets, or misrepresentations in the value of property or services, the promoter might, in an appropriate case, have been subject to (1) civil penalties for the preparation or presentation of a false or fraudulent return or other document as an income tax return preparer, or (2) the criminal penalties for aiding, assisting in, procuring, counseling or advising the preparation or presentation of a false or fraudulent return or other document under the internal revenue laws or for willfully attempting to evade or defeat any tax imposed under the internal revenue laws.

Reasons for Change

As of September 30, 1981, there were 248,828 returns containing tax shelter issues in the examination process, according to the 1981 Annual Report of the Commissioner of Internal Revenue. This represented an increase of 74,584 returns over the prior fiscal year. Congress believed that the widespread marketing and use of tax shelters was undermining public confidence in the fairness of the tax system and in the effectiveness of enforcement provisions and that these tax schemes place a disproportionate burden on the resources of the Internal Revenue Service.

Congress concluded that the penalty provisions of prior law were ineffective to deal with the growing phenomenon of abusive tax shelters, and that abusive tax shelters must be attacked at their source: the organizer and salesman. Congress recognized that the Securities and Exchange Commission has powers that may be directed toward some tax shelter promoters but believed that Internal Revenue Service enforcement in this area would materially contribute to a solution of this problem in a number of ways. For example, the Internal Revenue Service could be expected to approach the problem with vigor since prevention of abusive shelter promotions will require less manpower than enforcement actions against numerous investor-taxpayers. In addition, if the Internal

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 331; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 266-267; and H. Rep. No. 97-760 (August 17, 1982), p. 573 (Joint Explanatory Statement of the Committee of Conference).

Revenue Service establishes fraud by a promoter, the investors may be materially aided in their efforts to seek rescission of the contracts under which they invested. Finally, the promoter penalty was viewed as particularly equitable because the promoter, professional advisor or salesman of a tax shelter generally is more culpable than the purchaser who may have relied on their representations as to the tax consequences of the investment.

Explanation of Provision

The Act imposes a new civil penalty on persons who organize, assist in the organization of, or participate in the sale of any interest in a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement when, in connection with such organization or sale, the person makes or furnishes either (1) a statement which the person knows or has reason to know is false or fraudulent as to any material matter with respect to the availability of any tax benefit alleged to be allowable by reason of participating in the entity, plan or arrangement, or (2) a gross valuation overstatement as to a matter material to the entity, plan or arrangement, whether or not the accuracy of the statement of valuation is disclaimed. Thus, persons subject to the penalty may include not only the promoter of a classic tax shelter partnership or tax avoidance scheme, but any other person who organizes or sells a plan or arrangement with respect to which there are material inaccuracies affecting the tax benefits to be derived from participation in the arrangement. For example, the penalty could apply to some one organizing or selling an investment to or for a particular client. Moreover, the plan or arrangement need not be an investment; the term includes other activities such as the sale of mail-order ministries or family trust arrangements. A matter is material to the arrangement if it would have a substantial impact on the decision making process of a reasonably prudent investor.

The "knows or has reason to know" standard clarifies that the Secretary may rely on objective evidence of the knowledge of a promoter or salesperson (for example) to prove that he deliberately furnished a false or fraudulent statement. For example, a salesman would ordinarily be considered to have knowledge of the facts revealed in the sales materials which are furnished to him by the promoter. The "knows or has reason to know standard" was not, however, intended by Congress to be used to impute knowledge to a person beyond the level of comprehension required by his role in the transaction. Thus, this standard does not carry with it a duty of inquiry concerning the transaction beyond that implied by a person's role in the transaction.

A gross valuation overstatement is any statement or representation of the value of services or property which exceeds 200 percent of the correct value of the property or services and which is directly related to the amount of any income tax deduction or credit allowable to any participant. Although the valuation error must be more substantial than that required before the valuation overstatement penalty applies to the investor, Congress believed that such a limited penalty will prevent any unintended application. The penalty for gross valuation overstatement will have no effect on bona fide commercial or investment transactions in which, for example, a willing and knowledgeable buyer purchased from a willing and knowledgeable seller for cash because such a purchase price will define the value of the investment.

The penalty for promoting an abusive tax shelter is an assessable penalty equal to the greater of $1,000 or 10 percent of the gross income derived, or to be derived, from the activity. There need not be reliance by the purchasing taxpayer or actual underreporting of tax. These elements were not included because they would substantially impair the effectiveness of this penalty. Thus, a penalty can be imposed based upon the offering materials of the arrangement without an audit of any purchaser of interests. If the Internal Revenue Service cannot determine the entire amount of the gross income to be derived from an activity, it may assess the penalty on the present value of the portion of such gross income that may be determined. In determining the penalty with respect to the amount of gross income yet to be derived from an activity, the Secretary may look only to unrealized amounts which the promoter or other person may reasonably expect to realize.

The Secretary is given authority to waive all or part of any penalty resulting from a gross valuation overstatement, upon a showing that there was a reasonable basis for the valuation and the valuation was made in good faith. The mere existence of an appraisal is not sufficient, by itself, to show either reasonable basis or good faith. Rather, the Secretary may, for example, examine the basis for the appraisal, the manner in which it was obtained, and the appraiser's relationship to the investment or promoter.

This penalty is in addition to all other penalties provided for by law.

Effective Date

This provision took effect on the day after the date of enactment.

b. Action to enjoin promoters of abusive tax shelters, etc. (sec. 321 of the act and new sec. 7408 of the Code)*

Prior Law

Under prior law and present law, a civil action may be brought by the United States to enjoin any person who is an income tax return preparer from (1) engaging in any conduct subject to penalty under the income tax return preparer provisions or under the criminal tax laws, (2) misrepresenting his qualifications, (3) guaranteeing a refund or credit, or (4) engaging in any other fraudulent or deceptive conduct that substantially interferes with the proper administration of the tax laws. Venue for such an action lies in the district in which the income tax return preparer resides or has his principal place of business, or the taxpayer with respect to whose income tax return the action is brought resides. Injunctive relief may be granted by the district court if the court finds that such relief is appropriate to prevent recurrence of the prohibited conduct.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 332; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 268-269; and H. Rep. No. 97-760 (August 17, 1982), pp. 523 (Joint Explanatory Statement of the Committee of Conference).

In addition to its power to seek injunctions against persons violating the return preparer provision, the United States is empowered to seek, and the district court of the United Sates to grant, such decrees or orders, and processes (including injunctions) as may be necessary to enforce the internal revenue laws (sec. 7402(a)).

Reasons for Change

The Act provides for a penalty on promoters of investments in abusive tax shelters and other investments (see sec. 320 of the Act described above). Congress believed that the most effective way to curtail promotion of abusive tax shelters, etc., is through injunctions issued against violators to prevent recurrence of the offense. The ability to seek injunctive relief will insure that the Internal Revenue Service can attack tax shelter schemes years before such challenges would be possible if the Internal Revenue Service were first required to audit investor tax returns. Thus, Congress believed injunctive relief will better enable the Internal Revenue Service to protect the integrity of the tax laws and to protect innocent investors against widespread marketing of such tax schemes.

Explanation of Provision

The Act permits the United States to seek injunctive relief against any person who is engaging in conduct subject to the penalty for organizing or selling abusive tax shelters or other investments (sec. 320 of the Act, and new Code sec. 6700). Under the Act, these actions may be brought in the United States District Court for the district in which the promoter resides, has his principal place of business, or has engaged in the conduct subject to penalty under section 6700. If a citizen or resident of the United States does not reside in or have a principal place of business in any U.S. judicial district, such citizen or resident is treated as a resident of the District of Columbia.

The court may grant injunctive relief against any person if it finds (1) that the person has engaged in any conduct subject to the penalty for organizing or selling abusive tax shelters or other investments, and (2) that injunctive relief is appropriate to prevent recurrence of such conduct.

An injunction granted under this provision may prohibit the person enjoined from engaging in any activity subject to penalty under new section 6700. Of course, the court will continue to have full authority to act under its general equity jurisdiction (section 7402) and will continue to possess the great latitude inherent in equity jurisdiction to fashion appropriate equitable relief. For example, a court could enjoin particular conduct or enjoin all conduct violative of new section 6700. In addition, the court could enjoin any action tending to impede the proper administration of the tax law or any action which violates criminal statutes. See. *e.g., United States* v. *Landsberger,*—F. 2d—(8th Cir., July 29, 1982).

The commencement of any action under this provision does not in any way restrict the right of the United States to commence or carry on any other action against the organizer or seller.

Effective Date

The amendment took effect on the day after the date of enactment.

c. Procedural rules applicable to assessible penalties for promoting abusive tax shelters, aiding and abetting the underpayment of tax, and frivolous returns. (sec. 322 of the Act and new sec. 6703 of the Code) *

Prior Law

Under both prior and present law, the burden of proof is on the Secretary in any proceeding in which the issue is whether an income tax return preparer has willfully attempted to understate the liability for tax of any person (*i.e.*, violated section 6694(b)). Similarly, the burden of proof is generally on the Secretary to prove fraud. The deficiency procedures generally apply to the collection of additions to tax, additional amounts, and nonassessable penalties. Thus, jurisdiction is generally in the Tax Court to redetermine such additions to tax, additional amounts, and nonassessable penalties prior to their assessment and collection. Generally, except in the case of certain return preparer penalties (sec. 6694(c)), district court review of additions to tax, additional amounts or penalties (whether or not assessable), is not available before such amounts are fully paid.

In the case of a penalty imposed under the income tax preparer provisions, no levy or proceeding in court may be prosecuted to collect such penalty if, within 30 days after notice and demand the income tax return preparer pays 15 percent of such penalty and files a claim for refund of the amount paid. If the claim is denied or ignored, the income tax return preparer may file a suit in the district court to determine his liability for the penalty. During the pendency of such action, the statute of limitations on collection of such amount is suspended.

Reasons for Change

Congress believed that, since the new penalties on (1) promoters of abusive tax shelters, (2) persons aiding or assisting in the presentation of false or fraudulent documents under the Internal Revenue laws, and (3) persons filing frivolous returns are assessable, persons allegedly subject to these penalties should be entitled to the same procedural safeguards as are contained in the existing penalties on income tax return preparers.

Explanation of Provision

The Act provides for district court review of the Secretary's assessment and notice and demand of (1) the abusive tax shelter promoter penalty (sec. 320 of the Act), (2) the civil aiding and abetting penalty (sec. 324 of the Act), or (3) the frivolous return penalty (sec.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 333; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 270-271; and H. Rep. No. 97-760 (August 17, 1982), pp. 573-574 (Joint Explanatory Statement of the Committee of Conference).

326 of the Act), before the full amount of such penalties may be collected if certain procedural requirements are met. The review procedures are generally similar to those now provided with respect to the income tax return preparer penalties.

Thus, while the deficiency procedures do not apply to these penalties which are immediately assessable, provision is made for the prepayment review of the Secretary's assessment and notice and demand of such penalties if within 30 days after notice and demand of the penalty is made, the taxpayer pays 15 percent of the demanded amount and files a claim for refund. If the claim for refund is denied or ignored, the taxpayer may file suit in the district court to determine his liability for the amount claimed. No levy or proceeding to collect such penalty may be made during such 30-day period or if the taxpayer pays the 15 percent and files a claim for refund, until the claim is finally disposed of, either administratively or by final resolution of any district court review proceeding instituted by the taxpayer. The final resolution of any proceeding will occur when the decision of the district court is final. If the taxpayer fails to bring an action in the district court within 30 days of the earlier of denial of the refund or expiration of 6 months from the filing of the claim, the Secretary may proceed to collect the full amount of the penalty.

In any proceeding involving the issue of whether any taxpayer is liable for the tax shelter promoter penalty, the civil aiding or abetting penalty, or the frivolous return penalty, the burden is on the Secretary to prove the conduct giving rise to the penalty.

As in the case of the income tax return preparer penalties, the statute of limitations for collection of the amount assessed is suspended during the time the Secretary is prohibited from collecting the penalty under this provision.

The proceedings with respect to this penalty are separate from any review of tax liability to which the taxpayer may be entitled under any other provision of the tax laws. Thus, the district court's jurisdiction over a claimed penalty under this provision will not divest the Tax Court of jurisdiction over the taxpayer's liability for a claimed deficiency for that same taxable year.

Effective Date

This provision took effect on the day after the date of enactment.

d. Penalty for substantial understatement (sec. 323 of the Act and new sec. 6661 of the Code)*

Prior Law

Under both prior and present law, a penalty is imposed on the failure to pay certain taxes shown on a return (or if not paid within 10 days of notice and demand, an amount of tax required to be shown on a return) unless it is shown that such a failure to pay is due to reasonable cause and not willful neglect. If any portion of an underpayment of tax is due to negligence or intentional disregard of rules and regulations (negligence) but without intent to defraud, the addition to tax is equal to 5 percent of the entire underpayment. In addition, if the negligence penalty applies, an additional amount equal to 50 percent of the interest payable on that portion of the underpayment due to negligence, for the period running from the last date prescribed for payment of the tax (determined without regard to extensions) to the date the tax is paid, is imposed.

---

*For legislative background of the provision, see H.R. 4961, as reported by the Senate Finance Committee, sec. 341; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 272-274; Senate floor amendments, 128 Cong. Rec. S8789 and S8809 (July 21, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 574-576 (Joint Explanatory Statement of the Committee of Conference).

If any portion of an underpayment is due to fraud, then an addition to tax equal to 50 percent of the underpayment is imposed and (in the case of the income and gift taxes) the negligence penalty cannot be imposed. Further, if the fraud penalty is imposed, no penalty for failure to timely file a return or pay the tax may be imposed. Reasonable reliance on the advice of a tax advisor generally will prevent application of the fraud and negligence penalties.

In 1981, Congress enacted a "no-fault" penalty on valuation overstatements. Generally, under that provision, if a taxpayer makes a large error in placing too high a value on property which results in an understatement of tax, then a penalty measured as a percentage of the underpayment resulting from the valuation overstatement is imposed. Although the penalty is imposed without regard to fault, the Secretary may waive all or part of the penalty if there was a reasonable basis for the valuation and it was claimed in good faith. This penalty does not apply in the case of an overvaluation of services.

Reasons for Change

Congress believed that an increasing part of the compliance gap is attributable to taxpayers playing the "audit lottery." The audit lottery is played by taxpayers who take questionable positions not amounting to fraud or negligence on their returns in the hope that they will not be audited. If the taxpayer is audited and the questionable position challenged, then the taxpayer pays the additional tax owing plus interest. Under prior law, taxpayers were, generally, not exposed to any downside risk in taking questionable positions on their tax returns since resolution of the issue against the taxpayer required only payment of the tax that should have been paid in the first instance with interest to reflect the cost of the "borrowing." Taxpayers relied on opinions of tax advisors to avoid the possibility of fraud or negligence penalties in taking such questionable positions, even though the advisor's opinion may have clearly indicate that if the issue were challenged by the Internal Revenue Service, the taxpayer would probably lose the contest. Thus, in the event that the questionable position was not detected, the taxpayer achieved an absolute reduction in tax without cost or risk.

Congress believed, therefore, that taxpayers should be deterred from playing the audit lottery through the imposition of a penalty designed to deter the use of undisclosed questionable reporting positions. On the other hand, the Congress recognized that taxpayers and the Government may reasonably differ over the sometimes complex Federal tax laws, and that a penalty is not appropriate in many cases in which there is a large underpayment because there was substantial authority for the taxpayer's position. Finally, Congress believed that taxpayers investing in tax shelters should be held to a higher standard of care in determining the tax treatment of items arising from the shelter or risk a significant penalty.

Explanation of Provision

In general, under the Act, when there is a substantial understatement in income tax for any taxable year attributable to a filing position not disclosed by the taxpayer in the return, or for which the taxpayer did not have substantial authority, an addition to tax equal to 10 percent of the underpayment attributable to such understatement is imposed.

For this purpose, an understatement of income tax is the excess of the amount of income tax imposed on the taxpayer for the taxable year, over the amount of tax shown on the return. An understatement of income tax is substantial if the understatement for the taxable year exceeds the greater of 10 percent of the tax required to be shown on the return for the taxable year or $5,000 ($10,000 for corporations other than subchapter S corporations and personal holding companies). Thus, for example, in 1982 a married couple filing jointly would not be subject to the penalty unless they have taxable income in excess of approximately $27,900 and report no tax liability whatever. Similarly, a corporation would need a taxable income of approximately $30,300 (in 1982) before it could be subject to the penalty. Congress believed it was appropriate to exclude low and moderate income taxpayers from the scope of the penalty because of the greater access of higher income taxpayers to professional tax advice.

In determining whether an understatement is substantial, the amount of the understatement is reduced by any portion of the understatement attributable to the treatment of any item if (1) the treatment of the item on the return is or was supported by substantial authority or (2) in non-tax shelter cases, all of the facts relevant to the tax treatment of the item were disclosed on the return or in a statement attached to the return. Whether the taxpayer's filing position is or was supported by substantial authority depends on the circumstances of the particular case. It is necessary to weigh statutory provisions, court opinions, Treasury regulations and official administrative pronouncements (such as published revenue rulings and revenue procedures) that involve the same or similar circumstances and are otherwise pertinent (giving each its proper weight), as well as the Congressional intent reflected in the committee reports, to determine whether a particular position is supported by the law and may be taken with the good faith expectation that it reflects the proper treatment of the item. Congress did not adopt an absolute standard that a taxpayer may take a position on a return only if, in fact, the position reflects the correct treatment of the item because, in some circumstances, tax advisors may be unable to reach so definitive a conclusion. Rather, Congress adopted a more flexible standard under which the courts may assure that taxpayers who take non-disclosed highly aggressive filing positions are subject to the penalty while those who endeavor in good faith to fairly self-assess are not penalized.

The standard of substantial authority was adopted, in part, because it is a new standard. Congress was unaware of any relevant judicial or administrative decision interpreting the phrase "substantial authority." It was intended that the courts be free to look at the purpose of this new provision in determining whether substantial authority existed for a position taken in any particular case. Congress believed such a standard should be less stringent than a "more likely than not" (*i.e.,* more than 50 percent) standard and more stringent than a "reasonable basis" (*i.e.,* non-negligent) standard. This new standard will require that a taxpayer have stronger support for a position than a mere "reasonable basis." Thus, a taxpayer is required to have more support for his position than that it is arguable, but fairly unlikely to prevail in court upon a complete review of the relevant facts and authorities. Rather, when the relevant facts and authorities are analyzed with respect to the taxpayer's case, the weight of the authorities that support the taxpayer's position should be substantial when compared with those supporting other positions. In determining whether a position is supported by substantial authority, the courts are not bound by the conclusions reached in law review articles, opinion letters, or private letter rulings or determination letters and technical advice memoranda of the Internal Revenue Service issued to or concerning a third party, but will instead examine the authorities that underlie such expressions of opinion. Similarly, when a partner in a partnership or a shareholder of an S corporation treats an item on his or her return in a manner consistent with the treatment of the item on the return of the partnership or corporation, it will be necessary to examine the authorities that underlie the position taken on the partnership's or S corporation's return.

The substantial understatement penalty in non-tax shelter cases may be avoided with respect to any item if the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return. This disclosure relief permits taxpayers to avoid the penalty when there is uncertainty as to whether there is substantial authority for the treatment of the item. Under generally applicable regulatory authority, the Commissioner may prescribe the form of such disclosure. In no event, however, may such regulations require disclosure of attorney or accountant's work-papers. Disclosure is adequate if the taxpayer discloses facts sufficient to enable the Internal Revenue Service to identify the potential controversy, if it analyzed that information. This standard was intended to require greater disclosure than is necessary to avoid the six-year statute of limitations provided for in section 6501(e)(1)(A). For example, if a taxpayer has less than substantial authority for the position that an amount received was a business gift and therefore not includable in income, he may avoid a penalty by attaching a readily identifiable statement to his tax return disclosing the amounts received and the name and business relationship of the payor. Also, a taxpayer taking a bad debt deduction in a particular year, when there is a question as to the correct year in which the loss is allowable, could avoid the penalty by disclosing the relevant facts to the Secretary.

With respect to tax shelter items, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for his position, he reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. For this purpose, a tax shelter is a partnership or other entity, plan or arrangement the principal purpose of which, based on objective evidence, is the avoidance or evasion of Federal income tax. Congress believed that if the principal purpose of a transaction is the reduction of tax, it is not unreasonable to hold participants to a higher standard than ordinary taxpayers. Congress was also aware, however, that no reasonably informed business decision is made without regard to its tax effects.

The Secretary may waive the penalty with respect to any item if the taxpayer establishes reasonable cause for his treatment of the item and that he acted in good faith. A waiver could be appropriate, for example, if the taxpayer made a good faith mistake in deciding the proper timing of a deduction.

The Act establishes no special procedural rules with respect to the application of the substantial underpayment penalty. Thus, the usual deficiency procedures apply with respect to assessment and collection of the penalty. In litigation concerning liability for the penalty (including whether there is or was substantial authority for a position), the burden of proof falls upon the taxpayer.

Finally, this penalty applies only to that portion of the substantial understatement attributable to items on which the overvaluation penalty under section 6659 is not imposed.

Effective Date

This penalty is effective with respect to returns due after December 31, 1982 (without regard to extensions).

e. Penalties for aiding and abetting the understatement of tax liability (sec. 324 of the Act and new sec. 6701 of the Code)*

Prior Law

Under present and prior law, a criminal penalty is imposed on any person who willfully aids, assists in, procures, counsels, or advises the preparation or presentation of a false or fraudulent return, affidavit, claim, or other document under the internal revenue laws. A person convicted of this crime was punishable by a fine of up to $5,000 or 3 years imprisonment, or both, together with costs. The term "document" has been broadly interpreted in other contexts to include such items as matchbook covers submitted to the Tax Court (*Stein* v. *United States,* 363 F.2d 587 (5th Cir. 1966)), and affidavits supplied to the Internal Revenue Service during a criminal investigation (*United States* v. *Johnson,* 530 F.2d 52 (5th Cir. 1976), cert, denied, 429 U.S. 833).

This criminal penalty has been interpreted to apply to a variety of cases, including a race-track "10 percenter" who was convicted of filing a false Form 1099 even though the taxpayer's own name, address, and taxpayer identification number appeared on the return (*United States* v. *Snyder,* 549 F.2d 171 (10th Cir. 1977)), the preparer of false information returns for exempt organizations (*Beck* v. *United States*, 298 F.2d 622 (9th Cir. 1962)), and floor brokers in foreign exchange operations who provided false information to a taxpayer and, therefore, participated in the preparation of a fraudulent tax return (*United States* v. *Siegel,* No. 79 CR 606, N.D. Ill. (June 27, 1979), 79-2 U.S.T.C. ¶ 9698).

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 342; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 275-276; and H. Rep. No. 97-760 (August 17, 1982), pp. 576-577 (Joint Explanatory Statement of the Committee of Conference).

Under prior law, there was no comparable civil penalty on persons who aid or assist in the preparation or presentation of false or fraudulent documents under the internal revenue laws. However, income tax return preparers who willfully attempt to understate the liability for tax of any person were (and continue to be) subject to a penalty of $500 per return.

Reasons for Change

Congress believed that a new civil penalty analogous to the criminal penalty for aiding and abetting in the preparation or presentation of a false return or document under the internal revenue laws was necessary for the following four reasons. First, the penalty will permit more effective enforcement of the tax laws by discouraging those who would aid others in the fraudulent underpayment of their tax. Second, Congress felt that it is inappropriate to impose sizeable civil fraud penalties on taxpayers but to allow the advisors who aid or assist in the underpayment of tax to escape civil sanctions. Third, Congress recognized that certain types of conduct should be penalized but are not so abhorrent as to suggest criminal prosecution. Finally, Congress believed the new penalty will help protect taxpayers from advisors who seek to profit by leading innocent taxpayers into fraudulent conduct. It was anticipated that the Internal Revenue Service and Justice Department will continue to pursue vigorously the prosecution of criminal violations of the tax laws, including cases involving conduct that would also be subject to this new penalty.

Explanation of Provision

The Act provides for a new civil penalty on any person who aids, assists in, procures, or advises the preparation or presentation of any portion of a return, affidavit, claim or other document under the internal revenue laws which the person actually knows will be used in connection with any material matter arising under the tax laws, and which portion the person actually knows will (if used) result in an understatement of the tax liability of another person. The penalty was intended to apply as a civil counterpart to the criminal penalty on aiding or assisting in the preparation or presentation of false or fraudulent on returns or other documents.

No person will be subject to this penalty unless that person is directly involved in aiding or assisting in the preparation or presentation of a false or fraudulent document that will be used under the tax laws, or directly "procures" a subordinate to do any act punishable under this provision. The requirements that a person "know" that a document will be used in connection with a material matter arising under the tax laws and that the person "know" that the document, if used, will result in an understatement of tax were designed to limit the penalty to cases involving willful attempts to accomplish an understatement of the tax liability of a third-party.

Thus, for example, a tax advisor would not be subject to this penalty for suggesting an aggressive but supportable filing position to a client even though that position was later rejected by the courts and even though the client was subjected to the substantial understatement penalty. If, however, the tax advisor suggested a position which he knew could not be supported on any reasonable basis under the law, the penalty could apply. Thus, if a person prepares a return deducting an amount the preparer knows is not deductible that person could be subject to the penalty. However, if a person prepares a schedule or other portion of a return which portion is, in all respects, correct, that person will not be subject to this penalty even if he or she knows that one or more other portions of the return he or she does not help prepare and over which he does not have any control is fraudulent. The penalty does not apply to any person who merely furnishes typing, reproducing or other mechanical assistance in the preparation of the return, etc.

The term "procures" includes ordering or otherwise causing a subordinate to do an act subject to this penalty, or knowing of and not attempting to prevent participation of a subordinate in an act subject to this penalty. Thus, the penalty imposes an affirmative duty on supervisors to act to prevent the wrong proscribed by the provision when he knows it is occurring. The term "advises" includes acts of independent contractors such as attorneys and accountants in counseling a particular course of action. A "subordinate" is any person, including an agent, over which the person has direction, supervision, or control. Direction, supervision, or control for this purpose includes only direct and immediate direction, supervision, and control.

The burden of proof in imposing this penalty is on the Secretary. In addition, all of the other procedural rules described in section 322 of the Act apply to this penalty.

In general, this penalty is in addition to all other penalties provided by law except the penalty on income tax return preparers. If either the return preparer penalties or this penalty may apply with respect to any document the Secretary must elect which penalty to pursue. It is possible, however, for such a tax advisor to be subject to both this penalty and the promoter penalty (sec. 320 of the Act).

This penalty, which is $1,000 for each return or other document ($10,000 in the case of returns and documents relating to the tax of a corporation), can be imposed whether or not the taxpayer knows of the understatements. The penalty can, however, be imposed only once for any taxable period (or taxable event) with respect to documents relating to any one person. Thus, someone who assists two taxpayers in preparing false documents would be liable for a $2,000 penalty whereas the penalty would be only $1,000 if he had advised in the preparation of two false documents for the same taxpayer. Similarly, an advisor who prepares a false partnership return and ten false schedule K-1's for ten individual partners would be subject to an $11,000 penalty.

Effective Date

This provision was effective on the day after the date of enactment.

f. Fraud penalty (sec. 325 of the Act and sec. 6653 of the Code)*

Prior Law

Under prior law, if any portion of an underpayment of tax was due to fraud, a civil penalty was imposed (as an addition to tax) equal to 50 percent of the entire underpayment. Under prior law (and present law), if part of an underpayment is attributable to negligence or intentional disregard of rules and regulations, the penalty was equal to 5 percent of the entire underpayment plus 50 percent of interest payable on the portion of the underpayment attributable to negligence or disregard of rules and regulations for the period beginning on the last date prescribed for payment of the tax and ending on the date of assessment of the tax. This 50-percent-of-interest addition was adopted in 1981.

In the case of the windfall profit tax, both the negligence and the fraud penalty may apply to the same underpayment.

Reasons for Change

Congress decided that the fraud penalty should be conformed with the interest-addition feature of the negligence penalty, this will maintain the relative relationship between these two penalties and assure that the negligence penalty can never exceed the fraud penalty.

Explanation of Provision

The Act conforms the civil fraud penalty to the negligence penalty by providing that, in addition to the 50-percent fraud penalty on the entire underpayment, there is a penalty equal to 50 percent of the interest payable on the portion of the underpayment attributable to fraud for the period beginning on the last date prescribed for payment of the tax (without regard to any extension), and ending on the earlier of the date of assessment or the date of payment of the tax. Further, under the Act, the negligence penalty does not apply in any case (including an underpayment of windfall profit tax) in which the fraud penalty has been assessed.

Finally, when a joint return is filed, the interest addition does not apply with respect to the spouse's tax unless some part of the underpayment was due to the spouse's fraud.

Effective Date

The amendment applies to taxes the last day for payment of which (without regard to any extension) is after the date of enactment.

---

*For legislative background of the provision, see: H. Rep. No. 97-760 (August 17, 1982), pp. 577-578 (Joint Explanatory Statement of the Committee of Conference).

g. Penalty for frivolous returns (sec. 326 of the Act and new sec. 6702 of the Code)*

Prior Law

A taxpayer who files a protest return (such as one showing no tax due because the U.S. is no longer on the gold standard) may be subject to a penalty for failure to file a return, or for negligence or fraud. These penalties, however, are measured as a percentage of the underpayment of tax. Thus, under prior law, if a taxpayer paid at least the correct amount of tax through estimated tax or wage withholding, there was no penalty for filing a protest return. In addition, under prior law even when there was an underpayment, it could take several years of administrative and judicial proceedings before any penalty was imposed.

Reasons for Change

Congress was concerned with the rapid growth in deliberate defiance of the tax laws by tax protestors. The Internal Revenue Service had 13,600 illegal protest returns under examination as of June 30, 1981. Many of these protestors were induced to file protest returns through the criminal conduct of others. These advisors frequently emphasized the lack of any penalty when sufficient tax has been withheld from wages. Congress believed that an immediately assessable penalty on the filing of protest returns would help deter the filing of such returns, and would demonstrate the determination of Congress to maintain the integrity of the income tax system.

Explanation of Provision

The Act provides that an immediately assessable penalty of $500 is imposed on any individual who files any document which purports to be a return of income tax if (1) the document fails to contain information from which the substantial correctness of the amount of tax shown on the return can be judged or contains information that on its face indicates that the amount of tax shown on the return is substantially incorrect, and (2) such conduct arises from a position taken by the taxpayer on the purported return which is frivolous, or from a desire (which appears on the face of the purported return), to delay or impede the administration of the Federal income tax laws. The penalty will be imposed, therefore, only on purported returns that are patently improper and not in cases involving valid disputes with the Secretary.

For example, the penalty under this provision is immediately assessable against any individual who files, as a purported Form 1040, a document appearing to be a Form 1040, but which contains altered or incorrect descriptions of line items or other altered provisions. Such purported "returns" are not designed to inform the Secretary of the filer's taxable income and are not in processible form. The penalty will be immediately assessable against any individual filing a "return" in which many or all of the line items are not filled in except for references to spurious constitutional objections. Furthermore, the penalty is available against any individual filing a purported return in which insufficient information to calculate the tax is given or the information given is clearly inconsistent (as where an individual claims 99 exemptions but lists only a few dependents) or where the return otherwise reveals a frivolous position or a desire to impede the tax laws. Moreover, the penalty could be imposed against any individual filing a "return" showing an incorrect tax due, or a reduced tax due, because of the individual's claim of a clearly unallowable deduction, such as a "gold standard deduction" (i.e., a discount of dollars because the U.S. is not on the gold standard) or a "war tax" deduction under which the taxpayer reduces his taxable income or shows a reduced tax due by that individual's estimate of the amount of his taxes going to the Defense Department budget, etc. In contrast, the penalty also will not apply if the taxpayer shows the correct tax due but refuses to pay the tax. In such a case, of course, the Secretary can assess and collect the tax immediately. The penalty also will not be imposed if the taxpayer through mere inadvertence fails to use the correct tax table or makes mathematical errors on his or her return. If, however, the taxpayer deliberately uses incorrect tax tables, for example, to impede the tax system and the purported return otherwise satisfies the penalty requirements, the penalty will apply.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 343; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 277-278; and H. Rep. No. 97-760 (August 17, 1982), pp. 578 (Joint Explanatory Statement of the Committee of Conference).

This penalty is immediately assessable. The deficiency procedures, under which the taxpayer would receive advance notice before assessment, do not apply to this penalty. There is, however, a provision allowing for district court review of the assessment on payment of 15 percent of the amount assessed and the filing of a claim for refund of the amount paid if the refund claim is refused (see sec. 322 of the Act). This district court review is merely a determination of whether the penalty under this provision was properly imposed and is not a review of the taxpayer's actual liability for any income tax. The district court's opinion cannot, therefore, have any res judicata or collateral estoppel effect on the issue of the taxpayer's actual tax liability for the taxable year. This penalty is in addition to all other civil and criminal penalties provided by law.

Effective Date

This penalty applies to documents filed after the date of enactment.

h. Relief from criminal penalty for failure to file estimated tax where a taxpayer falls within statutory exceptions (sec. 327 of the Act and sec. 7203 of the Code) and Adjustments to Estimated Tax Provisions (sec. 328 of the Act and secs. 6654, 6015, 6073, and of 6153 of the Code)*

Prior Law

Individuals

Under prior law, individuals were required to declare and pay estimated taxes under certain circumstances. An individual who failed to pay in full an installment of estimated tax on or before the due date could be subject to a civil penalty. There was no penalty for failure to file a declaration of estimated tax.

There were four exceptions to the civil penalty for failure by an individual to pay estimated taxes. No penalty was imposed if: (1) total payments of estimated tax (withholding plus estimated tax payments) equaled or exceeded the amount shown as tax on the preceding year's return, if a return showing liability for tax was filed for the preceding year and such preceding year was a taxable year of 12 months; (2) total estimated tax payments generally equaled or exceeded 80 percent or, in certain cases 66⅔ percent of the tax which would be due if the income already received during the current year were placed on an annualized basis; (3) total tax payments equaled or exceeded 90 percent of the tax which would be due on the income actually received from the beginning of the year to the end of the month before the month in which the installment was due, as if such months constituted the taxable year; or (4) total tax payments equaled or exceeded the tax based on the facts shown on the return for, and the law applicable to, the prior year's return under the current year's tax rates and exemptions.

Corporations

Under both prior or present law, any corporation subject to tax is required to make payments of estimated tax if it reasonably expects to have an estimated tax liability for the taxable year of $40 or more. The estimated tax is payable in up to four installments over the taxable year.

In general, under prior law, if the amount of any estimated tax payment was not equal to the installment which would be required to be paid if the estimated tax were equal to 80 percent of the actual tax due, then a penalty was imposed, subject to certain exceptions.

Criminal penalty

In the case of both individuals and corporations, a criminal penalty is imposed for willful failure to pay any estimated tax at the time required by law. A person convicted for such willful failure is guilty of a misdemeanor and could, under prior law, be fined not more than $10,000 or imprisoned not more than 1 year (or both), together with the costs of prosecution. Under prior law, this criminal penalty could apply even if no civil penalty could be assessed because one of the exceptions listed above was satisfied.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 344; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 279-280; and H. Rep. No. 97-760 (August 17, 1982), pp. 579-580 (Joint Explanatory Statement of the Committee of Conference).

Reasons for Change

Congress believed the criminal penalty should expressly not apply when no civil penalty attaches to the underpayment of estimated taxes. The change merely codified prior administrative practice. Further, Congress believed that no civil penalty should apply to individuals who fail to pay estimated tax if the individual had no tax liability for the preceding taxable year. Finally, the requirement that individuals file declarations of estimated taxes was terminated after 1982 as unnecessary.

Explanation of Provision

The Act provides that any individual or corporation that fails to make any estimated tax payment, or underpays any estimated tax payment, is not subject to the criminal penalty for such failure if the civil penalty for such failure is not applicable because an exception to the civil penalty applies. In addition, the Act provides that no civil estimated tax penalty may be imposed on an individual if the individual had no tax liability for the preceding taxable year, such taxable year was a taxable year of 12 months, and the individual was a U.S. citizen or resident for the entire year.

Finally, the requirement for filing a declaration of estimated tax for individuals is terminated after 1982. Other provisions of law will, however, continue to function as if such declaration were filed. In addition, the requirement of prior law that a taxpayer must pay 100 percent of each installment when due is modified to require payment only of an amount computed by taking into account the penalty provisions.

Effective Date

The provision with respect to the criminal penalties is effective on the date of enactment. All the other provisions are effective for taxable years beginning after 1982.

i. Criminal fines (sec. 329 of the Act and secs. 7201, 7203, 7206, and 7207 of the Code)*

Prior Law

Under prior law, the penalties for major criminal tax offenses were as follows: (1) any person who willfully attempted to evade or defeat any tax or the payment thereof was guilty of a felony and, if convicted, could be fined not more than $10,000 or imprisoned for not less than 5 years, or both; (2) any person who was required to file a return or to pay any tax or estimated tax who willfully failed to do so was guilty of a misdemeanor and was punishable by a fine of not more than $10,000 or imprisonment for not more than 1 year, or both; (3) any person who willfully filed a false declaration under penalty of perjury, aided or assisted in the preparation of a false or fraudulent document, falsely executed any document under the internal revenue laws, concealed goods, etc., with the purpose of evading or defeating any tax or did certain other acts, was guilty of a felony and upon conviction could be fined not more than $5,000 or imprisoned for not more than 3 years, or both; and (4) any person who willfully delivered any false or fraudulent document to the Secretary, or did certain other acts, was guilty of a misdemeanor and could be fined not more than $1,000 or imprisoned for one year, or both.

---

*For legislative background of the provision, see: H. Rep. No. 97-760 (August 17, 1982), pp. 578-579 (Joint Explanatory Statement of the Committee of Conference).

Reasons for change

Congress believed that the maximum fine amounts, which had not been increased for many years should be raised to revitalize their deterrent effect.

Explanation of provision

The Act increases the maximum amount of fines under the above provisions as recommended by the Department of Justice. Thus, the maximum penalty for willful attempts to evade or defeat tax ((1) above) is increased from $10,000 to $100,000 ($500,000 for corporations); the maximum penalty for failure to file a return, etc. ((2) above) is increased from $10,000 to $25,000 ($100,000 for corporations); the maximum fine for filing false declarations, etc. ((3) above) is increased from $5,000 to $100,000 ($500,000 for corporations); and the maximum fines for delivery of false documents ((4) above) are increased from $1,000 to $10,000 ($50,000 for corporations). Congress intended that, as under prior law, these increased fines should continue to be treated as supplements to, and not substitutes for, imprisonment.

Effective date

These increases became effective with respect to offenses committed after September 4, 1982.

j. Special rules with respect to certain cash (sec. 330 of the Act and new sec. 6867 of the Code)*

Prior Law

Overview

In the usual case, the Secretary may not assess and may not make notice and demand for payment of any tax unless he follows certain procedures designed to allow the taxpayer to first contest the existence and amount of the alleged deficiency. These procedures include giving the taxpayer written notice of deficiency followed by a 90-day period (150 days in the case of notices to persons outside the United States) during which the taxpayer may petition the Tax Court for review of the Secretary's determination. No assessment may be made until after this 90-day period has expired or until after a decision of the Tax Court is final. This deficiency procedure need not be followed, however, when the Secretary reasonably believes that collection of an alleged deficiency will be jeopardized by delay. In such a case, the Secretary may declare jeopardy and immediately assess the tax, or may (in an appropriate case) terminate the taxpayer's taxable year and assess the tax due for that taxable period. The jeopardy and termination assessment procedures permit immediate assessment of an alleged tax deficiency without a pre-assessment notice of deficiency.

---

*For legislative background of the provision, see: H. Rep. No. 97-760 (August 17, 1982), pp. 580-583 (Joint Explanatory Statement of the Committee of Conference).

Both the jeopardy and termination assessment procedures require the Secretary to determine that there is a deficiency in tax and that the collection of this deficiency is in jeopardy. Under prior law, these procedures were not, therefore, well suited to cases in which the Secretary had reason to believe that a tax is owing with respect to an amount of property such as cash, but could not determine the proper owner of such property.

Jeopardy assessment

If the Secretary, generally through the district director, believes that the assessment and collection of a deficiency in income, estate, gift or certain excise taxes will be jeopardized by delay, he may assess such deficiency and demand its immediate payment together with any interest, additional amounts and additions to tax provided for by law. The Secretary may reasonably believe that a collection of a tax is in jeopardy where, for example, the taxpayer designs to depart quickly from the United States or to conceal himself, to place quickly his property beyond the reach of the United States, or the taxpayer's financial solvency is imperiled. If after assessment, notice, and demand the taxpayer fails to pay the assessed amount, the Secretary may immediately enforce collection, subject to the right of the taxpayer to stay the enforcement proceedings by posting a bond.

Collection of the amount jeopardy assessed, or any portion thereof, may be stayed by the taxpayer by filing a bond with the Secretary equal to the amount with respect to which the stay is desired. In such a case, the bond must be conditioned upon the payment of the amount finally determined to be owing when due. Generally, if assessment is made and property seized for collection of the assessed amount, the property may not be sold until after the taxpayer has an opportunity for District Court review of the reasonableness of the assessment and the amount thereof, and (if applicable) the date on which a Tax Court decision with respect to the taxpayer's actual tax liability is final.

Termination assessment

When the Secretary finds that the collection of income tax for the current or immediately preceding taxable year is in jeopardy because the taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property, or to do any other act tending to prejudice proceedings to collect such tax, he may immediately terminate such taxable year, and assess and demand any deficiency he reasonably believes owing with respect to the taxable period terminated. A termination assessment is appropriate with respect to the income tax for the current taxable year or the preceding taxable year, but not after the due date (with extensions) of the return for the preceding taxable year. In all other situations, the jeopardy assessment provisions apply and the termination provision does not.

In the case of the current taxable year which is terminated under the termination provision, the portion of the current taxable year starting on the first day of the current taxable year and ending on the determination date, is treated as a separate taxable year. The taxpayer's tax for the period (less any prior termination assessments) is then computed and assessed and notice and demand therefor made. Any tax collected is treated as a payment of tax for the applicable taxable year.

Judicial review of assessment

In both the jeopardy and termination assessment cases, the taxpayer is entitled to an expedited review by the Secretary, through the district director, of whether the determination of jeopardy was reasonable under the circumstances and whether the amount assessed and demanded was appropriate under the circumstances.

After review by the district director, the taxpayer is also entitled to a review by the appropriate United States District Court. In the District Court, the Secretary has the burden of proving that the determination of jeopardy was reasonable under the circumstances, while the taxpayer has the burden of proof with respect to the amount assessed. This review procedure is directed only at the reasonableness of the jeopardy assessment and the amount assessed. The District Court's opinion is nonappealable, and is not a determination of the actual existence or amount of any deficiency due from the taxpayer.

In making their respective determinations, the district director and District Court both may refer to information which became available after the assessment is made.

The taxpayer is also entitled to a separate review by the District Court or Tax Court of the actual existence of any tax deficiency on which the jeopardy assessment was based. To facilitate this review, the Commissioner must, in the case of a termination assessment, mail a notice of deficiency to the taxpayer within 60 days of the later of the due date of the taxpayer's return for the taxable year in which or for which the termination assessment was made (with extensions), or the date the taxpayer files such return. While the Secretary may terminate a taxable year more than once, he need not send out the notice of deficiency until after the close of the taxable year. In the case of a jeopardy assessment, the Secretary must mail a notice of deficiency within 60 days of the assessment if one has not already been mailed.

Reasons for Change

The termination and jeopardy procedures are designed to address the case in which the Secretary reasonably believes, from all the circumstances, that a deficiency in tax is owing from a particular taxpayer and that the collection of such deficiency is in jeopardy. It was unclear under prior law whether the jeopardy and termination procedures were available to the Secretary when cash or its equivalent could not be associated with any particular person and the Secretary could not, therefore, determine a deficiency in tax or its amount for an identifiable person. Congress determined that the jeopardy and termination procedures should be available when a large amount of cash or its equivalent could not be associated with a particular taxpayer.

Explanation of Provision

The Act adds a new provision designed to expedite jeopardy or termination assessments when there is no known owner of large amounts of cash.

The Act provides that the Secretary can presume that the collection of an amount of income tax is in jeopardy when an individual in physical possession of more than $10,000 of cash or its equivalent denies ownership of the cash and does not claim that such cash belongs to another person the identity of whom is readily ascertainable by the Secretary (and who acknowledges ownership). In such a case, the Secretary may presume, for purposes of the jeopardy or termination assessment provisions (1) that such cash represents gross income to a single individual for the taxable year of possession taxable at a 50 percent rate, and (2) that the collection of the tax on such cash would be jeopardized by delay. The Internal Revenue Service cannot assess on the same cash twice.

Notice with respect to the assessment must be given to the person found in possession of the cash. However, since that person denies ownership of the cash, he may not prosecute any action with respect to the cash. However, the true owner of the cash can come forward and challenge the assessment and will be substituted retroactively for the possessor for all purposes (including establishing lien priorities) as of the date of the original assessment. In addition, the true owner will continue to have the same rights as existed under prior law to recover his cash. Thus, the rights of the true owner will date from the date of the original assessment. For example, of the true owner does not request administrative review within the proscribed time period, as measured from the original assessment, he will forfeit this right.

The terms "cash" and "cash equivalent" include cash, foreign currency, any bearer obligation and any other medium of exchange which is of a type used frequently in illegal activities and specified as a cash equivalent by the Secretary in regulations. In the usual case, a cash equivalent will be valued at its fair market value, except that a bearer obligation will be deemed to have a value equal to its face amount.

Effective Date

This provision was effective the day after the date of enactment.

4. Administrative Summonses

a. Special procedures for third-party summonses and duty of third-party recordkeepers (secs. 331 and 332 of the Act and sec. 7609 of the Code)*

Prior Law

Under prior law, if an administrative summons was served on a third-party recordkeeper summoning that person to produce the records made or kept by the third-party recordkeeper with respect to the business transactions or affairs of a person other than the person summoned, then notice of the summons was also required to be given to the person whose records had been summoned (the noticee) within 3 days of the day on which the summons was served but not less than 14 days of the day fixed to examine the records. Such notice had to be accompanied by a copy of the summons served and had to contain directions and materials on how the noticee could stay compliance with the summons. For these purposes, a third-party recordkeeper was a bank or similar financial institution, a consumer reporting agency, a credit card company, a brokerage house, an attorney, or an accountant.

The noticee could stay compliance with a third-party summons if the noticee notified the recordkeeper in writing, not later than the 14th day after the day notice was given, not to comply with the summons and mailed a copy of this notice to the Secretary by registered or certified mail. To enforce the summons, the Secretary then had to seek an order of a United States District Court compelling compliance, at which time the third-party recordkeeper or the noticee could assert its defenses for noncompliance. Unless the noticee staying compliance consented, no examination of the summoned records could be made until the expiration of the period for notice not to comply or, if such notice was given, until the court authorized examination.

To enforce third-party recordkeeper summonses, the Secretary must meet the requirements set out by the Supreme Court in *United States* v. *Powell*, 379 U.S. 48 (1964). Thus, the Secretary must show that (1) the investigation will be conducted pursuant to a legitimate purpose, (2) the inquiry may be relevant to that purpose, (3) the information sought is not already within the Commissioner's possession, and (4) the administrative steps required by the Internal Revenue Code have been followed.

In addition, the Secretary must at all times use his summons authority in good faith pursuant to the Congressionally authorized purposes described in section 7602. Under prior law, these purposes were (1) asertaining the correctness of any return, (2) making a return where none has been made, (3) determining the liability of any person for any internal revenue tax, or (4) collecting any such liability. A summons, including a third-party summons, was authorized only for those prescribed purposes.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, secs. 351 and 352; S. Rep. No. 97-494, Vol 1 (July 12, 1982), pp. 281-284; and H. Rep. No. 97-760 (August 17, 1982), pp. 583-584 (Joint Explanatory Statement of the Committee of Conference).

Pursuant to a purpose specified in section 7602, a summons could be issued to summon a person liable for a tax or required to perform an act, or any person having possession, custody, or care of the books of account of such a person, or to summon any other person the Secretary deemed proper to appear before the Secretary and to produce such records or give such testimony as was relevant to the inquiry. In general, a summons issued to determine the identity of a person having a numbered account (or similar arrangement) with a bank or similar financial institution, or in aid of the collection of tax from a person against whom an assessment had been made or judgment rendered, or in aid of the collection of tax from a transferee or fiduciary of a person against whom an assessment had been made, was not treated as a third-party recordkeeper summons.

Under prior law, there was no requirement that third-party recordkeepers immediately proceed to assemble summoned records.

Reasons for Change

The prior law rules relating to summonses of third-party recordkeepers were enacted in 1976 to protect the rights of persons whose records were held by third parties. However, the automatic stay provisions enacted in 1976 were such that noticees have frequently delayed enforcement of summonses without regard to the merits of any objection they might have. As a result, the Internal Revenue Service prevailed in the vast majority of actions it brought to enforce third-party summonses. Indeed, most noticees failed to contest the summonses when the Internal Revenue Service sought enforcement.

Congress believed that shifting the burden of commencing litigation with respect to the validity of a third-party recordkeeper summons would eliminate most of the fruitless delay permitted under prior law without adversely affecting the rights of noticees.

Delay also occurred under prior law because recordkeepers hesitated to incur the expense of complying with third party summonses until they were certain that the noticee had not contested the summons. Congress believed that recordkeepers should prepare to comply as soon as possible, and that recordkeepers should be protected from liability for wrongful disclosure when the Internal Revenue Service certifies that the noticee is not contesting the summons.

At the same time, Congress believed that barter exchanges ought to be granted status as third-party recordkeepers. This is because barter exchanges often hold records for their customers or keep records of barter exchange transactions. Such records may have tax significance. Customers of barter exchanges are, therefore, entitled to the procedural protections which derive from third-party recordkeeper status.

Explanation of Provision

Right to petition for quash of summons

Under the Act, a noticee whose records are summoned and who is, therefore, entitled to notice of the summons and who wishes to prevent compliance with the summons by the recordkeeper, must begin a civil action in court to quash the summons not later than the 20th day after the day notice of the summons is given. Subject only to the local rules of the relevant Federal district court, the directions and materials provided with the summons should enable the noticee to make the filing to quash the third-party summons.

If the noticee initiates a proceeding to quash the summons, the noticee is required to mail (by registered or certified mail) a copy of the petition to the recordkeeper, and a copy to the Secretary, within this 20-day period. Unless the noticee whose records were summoned consents, no examination of the summoned records is allowed before the close of the twenty-third day after notice is given (17th day under prior law), or if a proceeding to quash is begun, until the court so orders or the taxpayer consents.

Congress intended that all matters relating to the third-party summons would be resolved by the court in any proceedings instituted by the noticee under this provision. Thus, the Secretary could use this occasion to seek to compel compliance with the summons. The recordkeeper has the right to intervene in the proceeding to quash the summons, and is bound by any decision in such proceeding, even if it does not intervene.

Jurisdiction with respect to such actions resides in the district court for the district in which the summoned person resides or is found. Generally, therefore, venue in such a case will be in the judicial district where summons is served on the third-party recordkeeper.

An order of the district court denying the petition to quash this summons is a final, appealable order. No change was made by the provision with respect to appeals rights and procedures and the conditions under which stays of enforcement may be granted because Congress believed the relatively strict attitude adopted by the courts under prior law is appropriate and that the rules governing appeals and stays should continue to be developed in a flexible manner by the courts.

Although an action to quash the summons must be instituted by the noticee, the ultimate burden of persuasion with respect to its right to enforcement of the summons remains on the Secretary, as under prior law. Thus, the Secretary must meet all the requirements of *United States* v. *Powell,* 379 U.S. 48 (1964), including a showing that the individual investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to that purpose, that the information sought is not already within the Commissioner's possession, and that all the administrative steps required by the Internal Revenue Code have been followed. As a defense to the enforcement of the summons, the taxpayer may show that the taxpayer's case has been referred to the Department of Justice (see, Limitation on Use of Administrative Summonses, sec. 333 of the Act).

Duty of third-party recordkeepers

The Act requires third-party recordkeepers to proceed to assemble summoned records upon receipt of the summons and to be prepared to produce the records on the date specified for their examination. Thus, the recordkeeper is not permitted to wait until after the 20-day period in which the taxpayer would have the right to seek to quash the summons before assembling the summoned records. Of course, such recordkeepers may be entitled to reimbursement for their costs under section 7610 regardless of whether the summons is enforced. After expiration of the 23-day period, the Act permits the Secretary to certify to the recordkeeper that no proceeding to quash had been initiated or that the noticee has consented to compliance with the summons. Any recordkeeper who makes a disclosure of records pursuant to a court order or in reliance on the Secretary's certification that no proceeding to quash had been commenced or that the noticee has consented to compliance with the summons is not liable to the taxpayer for the disclosure.

Effective Date

The provisions are applicable with respect to summonses initially served after December 31, 1982.

b. Limitation on use of administrative summonses (sec. 333 of the Act and sec. 7602 of the Code)*

Prior Law

Under prior law, the Secretary could issue summonses for the purpose of ascertaining the correctness of any return, making a return where none had been made, determining the liability of any person (including transferees or fiduciaries) for any internal revenue tax, or collecting any such liability. In pursuit of one of these purposes, the Secretary was authorized to examine any books, records, etc., which could be relevant or material to such an inquiry; to summon the person liable for the tax, or required to perform the act or any officer or employee of such person, or any third-party recordkeeper, or any other person the Secretary deemed proper, to produce such books, records, etc., or give such testimony under oath as may be material or relevant to such inquiry.

In order to enforce such an administrative summons, the Secretary was required to meet the requirements of *United States* v. *Powell,* 379 U.S. 48 (1964) *(Powell)* and *United States* v. *LaSalle National Bank, et al,* 437 U.S. 298 (1978) *(LaSalle).* Under *Powell,* the Secretary must show that (1) the investigation will be conducted pursuant to a legitimate purpose, (2) the inquiry may be relevant to that purpose, (3) the information sought is not already within the Commissioner's possession, and (4) the administrative steps required by the Internal Revenue Code have been followed. In addition, the Secretary is required at all times to use the summons authority in good faith in pursuit of the Congressionally authorized purposes described in section 7602. Under *LaSalle,* the Secretary could not use an administrative summons once the Internal Revenue Service had referred the case to the Department of Justice for prosecution, or had made an institutional commitment to refer the case to the Department for criminal prosecution.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 353; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 285-287; and H. Rep. No. 97-760 (August 17, 1982), p. 584 (Joint Explanatory Statement of the Committee of Conference).

Reasons for Change

Under *LaSalle,* the Secretary could not use an administrative summons once the Internal Revenue Service had referred a case to the Department of Justice for prosecution or had made an institutional commitment to refer a case to the Department for criminal prosecution. The prior law rule that spawned protracted litigation concerning the existence of any institutional commitment of the Service without meaningful results for taxpayers. Congress believed that summons enforcement proceedings should be summary in nature and discovery should be limited. See *United States* v. *Kis,* 658 F.2d 526 (7th Cir. 1981).

Many tax investigations by the Internal Revenue Service have both civil and criminal aspects. Congress believed that a clear definition of when the power to issue an administrative summons exists and when it does not exist in cases with a criminal aspect would simplify administration of the laws without prejudicing the rights of taxpayers. Thus, the Act establishes a mechanical test for determinating when the power to issue a summons ceases to exist. To permit the drawing of a clear distinction, it was necessary to expand the purposes for which an administrative summons may be issued by the Internal Revenue Service.

Explanation of Provision

Under the Act, the Secretary may not issue any summons or commence any action to enforce a summons if a Justice Department referral is in effect with respect to the person whose tax liability is in issue. A Justice Department referral is in effect with respect to any person if the Secretary recommends to the Attorney General either (1) a grand jury investigation or (2) criminal prosecution of such person for any offense connected with the internal revenue laws, or (3) the Attorney General (or Deputy Attorney General or Assistant Attorney General) makes a written request to the Secretary for a return of, or return information relating to, a taxpayer which request sets forth the need for disclosure for tax administration purposes. A Justice Department referral ceases to exist when the Attorney General notifies the Secretary, in writing, that he will not prosecute such taxpayer for any offense connected with the administration or enforcement of the internal revenue laws; that he will not authorize a grand jury investigation of such person with respect to such offense; that he will discontinue any such grand jury investigation; that a final disposition has been made of any criminal proceeding pertaining to the enforcement of the internal revenue laws which was instituted by the Attorney General against such taxpayer; or the Attorney General, Deputy Attorney General, or an Assistant Attorney General notifies the Secretary, in writing, that he will not prosecute such person for any offense connected with the administration or enforcement of the internal revenue laws and which relates to any written request for return or return information.

Each taxable period (or, in the case of excise taxes, each taxable event) must be treated separately. Thus, the Secretary may issue a summons for one taxable year even if a Justice Department referral is in effect with respect to the taxpayer for another taxable year. Moreover, once a Justice Department referral ceases to exist for a taxable period, the Secretary may issue a summons to pursue either a criminal or civil investigation for that period.

Under prior law, the use of administrative summonses was limited to the determination and collection of taxes. The Act expands this authority to include the right to issue a summons for the purpose of inquiring into any offense connected with the administration or enforcement of the Internal Revenue laws, even when the criminal investigation is the sole investigation.

The Act does not in any way alter the other requirements under prior law that the Secretary make the showings required under *Powell.* Further, this provision is in no way intended to broaden the Justice Department's right of criminal discovery or to infringe on the role of the grand jury as a principal tool of criminal accusation. Congress expected that the Justice Department would continue to have primary responsibility for criminal prosecutions under the tax laws.

Effective Date

This provision became effective the day after the date of enactment.

5. Pension Withholding and Recordkeeping

a. Withholding on pensions, annuities, and certain other deferred income (sec. 334(a) and (d) of the Act and secs. 3402 and 3405 of the Code)

Prior Law

Under prior law, income tax generally was not required to be withheld from benefits paid under a tax-qualified pension, profit-sharing, or stock bonus plan, under a tax-sheltered annuity program or under an IRA (an individual retirement account or annuity or a U.S. retirement bond). Also, payments under a commercial annuity contract generally were not subject to withholding. However, tax was required to be withheld on an annuity payment if a voluntary withholding request by the recipient was in effect.

Reasons for Change

Congress concluded that a more effective withholding system which applies both to annuities and other types of distributions from pension, etc., plans will assist taxpayers in better understanding and complying with the tax laws in regard to pension payments and will relieve these taxpayers of estimated tax burdens and penalties. In particular, Congress believed that a wage-based voluntary withholding system will reduce recordkeeping and estimated tax burdens on the elderly.

Explanation of Provision

Withholding required

The Act provides that payors generally will be required to withhold tax from all designated distributions (the taxable part of payments made from or under a pension, profit-sharing, stock bonus, or annuity plan, an employer deferred compensation plan where the payments are not otherwise considered wages, an IRA, or a commercial annuity contract (whether or not the contract was purchased under an employer's plan for employees)). A commercial annuity is an annuity, endowment, or life insurance contract issued by an insurance company licensed to do business under the laws of any State. Certain loans from employee plans and IRAs will also be considered distributions subject to withholding. The Act does not change the withholding rules with respect to payments made to nonresident aliens.

Whether a plan is an employer deferred compensation plan is determined under the usual income tax rules. For example, payments of the distributive share of a retiring partner's partnership interest are not considered payments from or under an employer deferred compensation plan.

The withholding rate on a designated distribution is determined by the nature of the distribution. Tax will be withheld on periodic payments (typically, annuity payments) as if those payments were wages paid by an employer to an employee for the appropriate payroll period (subject to the usual rules for personal and other exemptions from withholding). The Act does not permit a payee to designate a specified dollar amount to be withheld in lieu of wage withholding. It is anticipated that the Secretary of the Treasury will provide guidance to determine the appropriate payroll period. Because tax will generally be withheld on periodic payments pursuant to the recipient's withholding certificate, a married recipient whose spouse is not a wage earner will not be subject to withholding tax on periodic payments payable at an annual rate of up to $6,400 (for 1983), if both the wage earner and the wage earner's spouse are at least age 65 and a withholding certificate is filed. If no certificate is filed, the amount withheld will be determined by treating the payee as a married individual claiming three withholding exemptions. Thus, for 1983, there would be no withholding on pensions payable at an annual rate of $5,400 or less. However, to prevent possible under-withholding where a recipient has other income, and to insure that recipients are aware that periodic payments are taxable, a payor will still be required to notify every annuity recipient of the withholding rules.

For nonperiodic payments, tax generally will be withheld at a 10 percent rate. In the case of a qualified total distribution (generally, a distribution within one taxable year of the recipient, of the balance to the credit of the participant under a qualified pension, etc., plan (sec. 401(a) or 403(a)), tax will be withheld under special rules designed to reflect the 10-year forward income averaging and capital gains treatment provided for lump sum distributions. In the case of a qualified total distribution under a qualified pension, etc., plan or a tax-sheltered annuity contract (sec. 403(b)) which is made on account of a participant's death, the withholding rules will take into account the exclusion provided for employer-provided death benefits (whether or not actually allowable to the payee).

Under the Act, accumulated deductible employee contributions (sec. 72(o)(5)(B) under an employer's plan are treated separately in determining if there has been a qualified total distribution.

With respect to any designated distribution, the maximum amount withheld is not to exceed the sum of the amount of money and the fair market value of other property (other than employer securities (within the meaning of sec. 402(a)(3))) received in the distribution. Thus, no payor will be required to liquidate employer securities qualifying for special deferral of net unrealized appreciation merely to satisy the withholding rules. In addition, no payor will be required to withhold on a loan amount which is treated as a distribution made on a date subsequent to the date on which the loan was made.

Elections

Under the Act, recipients may elect, for any reason, not to have the withholding rules apply to any distribution (whether a periodic payment or a nonperiodic payment). A recipient's election with respect to periodic payments is effective until revoked. A recipient's election with respect to a nonperiodic payment generally will be effective only for the distribution for which it is made. However, to the extent provided in regulations to be issued by the Secretary of the Treasury, an election may apply to subsequent nonperiodic payments made by the payor to the payee under the same plan or arrangement.

Notices

Payors are required to notify recipients of their right to elect not to have the withholding rules apply, including the right to renew or revoke such an election. Congress expects that the notice will also advise recipients that penalties may be incurred under the estimated tax payment rules if the payments of estimated tax are not adequate and sufficient tax is not withheld from any designated distributions. The form and content of the notice will be determined by the Secretary of the Treasury.

For periodic payments, the notice is required not earlier than 6 months before the date on which the payor anticipates that the first payment will be made, and not later than when making the first payment. In addition, in every case, the notice is required to be provided to the recipient when making the first payment. For purposes of the withholding rules relating to periodic payments, if the payments are suspended (for example, by reason of a retiree's return to the service of the employer), the first periodic payment made after the suspension will be treated as a first periodic payment. In addition, the Act requires that payors of periodic payments notify payees at least once each year of the right to make, renew, or revoke the withholding election.

With respect to a nonperiodic payment, the Act requires the payor to provide notice of the right to elect not to have income tax withheld at the time of the distribution. The Act also permits Treasury regulations to require earlier notice by the payor in certain cases. For example, unless recipients of lump sum distributions are notified of their rights to elect not to have withholding apply before they receive their distributions, they may be unable to transfer the full amount eligible for a tax-free rollover. In order to prevent this result it is anticipated that Treasury regulations will require that recipients of total distributions from qualified plans be informed, within a reasonable time before plan distributions are made, of their right not to have withholding apply.

Liability for withholding

The payor of a designated distribution generally is required to withhold tax from the distribution and is liable for payment of the tax withheld. However, with respect to a tax-qualified pension, etc., plan (sec. 401(a) or 403(a)), or an employee stock ownership plan maintained pursuant to section 301(d) of the Tax Reduction Act of 1975, the plan administrator (sec. 414(g)) is required to withhold and is liable for withheld tax, unless the plan administrator (1) directs the payor of any designated distribution to withhold the tax, and (2) provides the payor such information with respect to such withholding as the Secretary of the Treasury may require by regulations.

Annuity payments and other distributions under the Civil Service Retirement System are subject to the income tax withholding rules. Congress intends that the cost of administering the withholding rules will be borne by the Civil Service Retirement System.

Coordination with other provisions

The Act's rules for designated distributions will not apply to amounts paid as wages subject to the usual wage-withholding rules. In addition, the rules of prior law for income tax withheld from wages will apply to amounts withheld from designated distributions. With respect to designated distributions, the Act replaces the provisions of prior law which permitted voluntary withholding on amounts paid as an annuity.

Effective Date

In general, the withholding rules apply to designated distributions made after December 31, 1982. For purposes of applying the rules to periodic payments which commence prior to January 1, 1983, the first periodic payment after December 31, 1982, is considered the first periodic payment made. Thus, unless the recipient otherwise elects, withholding is required with respect to any periodic payment made after December 31, 1982, and the payor must notify the recipient of his right to elect not to have withholding apply no later than when making such payment.

Congress recognized the difficulty some payors may have in immediately complying with the new withholding requirements for annuity payments. Accordingly, the civil and criminal penalties for failure to withhold tax will not apply to any failure before July 1, 1983, if the payor made a good faith effort to withhold, and actually withholds from payments made after July 1, 1983, and before January 1, 1984, sufficient amounts to satisfy the pre-July 1983 requirements. No relief is provided for any failure to timely pay over any amounts that are in fact withheld. Also, the Secretary is authorized, on a case-by-case basis, to exempt payors from any obligation to withhold with respect to pre-July 1983 payments if the payor has attempted to comply in good faith, has a plan to assure its ability to comply by July 1, 1983, and cannot comply on January 1, 1983, without undue hardship. If such a waiver of the withholding obligations is granted, the payor will not be required to make up the withholding obligation out of post-June 1983 payments.

b. Pension reporting and recordkeeping requirements (Sec. 334(a) and (b) of the Act and secs. 6047 and 6704 of the Code)

Prior law

Under prior law, distributions under a tax-qualified pension, etc., plan or annuity contract were required to be reported only if the amount includible in income totaled $600 or more for the calendar year. Distributions from an IRA are required to be reported without regard to the amount of the distributions. Penalties generally apply to any person failing to file a required report.

Under prior law, no separate penalty was imposed for failure to maintain a data base sufficient to provide required reports.

Reasons for Change

Congress believed that is to important for participants and the Internal Revenue Service to have the information necessary to determine the proper tax treatment of pension distributions, and that it is more efficient to require such informatin to be provided by the relatively more sophisticated and automated payors of pensions than the individuals who receive pensions. Further, to insure that payors can provide accurate information to participants and the Internal Revenue Service, the Congress concluded that it is necessary to insure that payors maintain adequate records.

Explanation of Provisions

Reports

To improve compliance, the Act provides for reporting of necessary information by employers, plan administrators, and issuers of insurance or annuity contracts. The form and manner of reporting will be determined under forms or regulations prescribed by the Secretary of the Treasury. Congress expects that these reports will include information sufficient to identify the total amount of the distribution, the amount of accumulated deductible employee contributions, the amount of nondeductible employee contributions, the amount of capital gain, the amount of ordinary income, the cost basis of any employer securities included in a distribution, and possibly, in the case of qualified total distributions, information regarding the 5-year rule and separation from service rule, and such other information as the Secretary, by forms or regulations requires.

For purposes of the Act's reporting rules, an exchange of insurance contracts under which any designated distribution may be made (including a section 1035 tax-free exchange) is intended to be a reportable event even though no designated distribution occurs in the particular transaction. Thus, to insure proper reporting of any designated distributions under the new contract it is anticipated that, under regulations to be issued by the Secretary, the issuer of the contract to be exchanged will be required to provide information to the policyholder, the issuer of the new contract, and such other persons as the Secretary may require.

Recordkeeping

The Act also provides a new penalty where the data base needed for reports is not maintained. The penalty applies whether or not reports are due for the period during which the recordkeeping failure occurs. No penalty will be imposed for a failure to meet the recordkeeping rules when the failure is due to reasonable cause and not willful neglect. Also, no penalty will be imposed on a person for a recordkeeping failure that is due to a prior failure with respect to which the penalty has already been imposed on that person or for a recordkeeping failure which occurs before

1983, if all reasonable efforts have been made to correct the prior failure.

With respect to post-enactment data, it is expected that these recordkeeping requirements will be strictly enforced. However, to the extent that a person is required to determine required information applicable to pre-1983 service, a person shall be treated as having made all reasonable efforts to correct a pre-1983 recordkeeping failure if such person uses whatever records may be reasonably accessible and makes whatever calculations are necessary to determine the required information. For example, if a plan or an employer maintaining the plan has, or has access to, only the plan documents and the records of employee compensation for the pre-1983 period, it may derive employer and mandatory employee contributions based on that data.

If the employer or the employee has payroll data indicating amounts of contributions made through payroll withholding, those records may be used to derive voluntary employee contributions, mandatory contributions and, if applicable, matching employer contributions.

If accessible records are insufficient to make an approximation of the required information, the person may make a reasonable estimate. For example, if records are available with respect to a representative number or employees, the person may estimate information for other similarly situated employees based on those records.

Effective Dates

The reporting requirements and voluntary withholding rules are effective on January 1, 1983, and the recordkeeping penalties are effective on January 1, 1985.

c. Partial rollovers of IRA distributions (sec. 335 of the Act and sec. 408 of the Code)

Prior Law

Amounts received from an individual retirement account or annuity (IRA) generally are taxed in full as ordinary income, because neither the contributions nor the earnings thereon have been subject to tax previously (sec. 408(d)). However, an exception is provided for certain distributions which are rolled over to another eligible retirement plan. There is no requirement that the entire balance in the IRA be distributed, but under prior law the distribution qualified for tax-free rollover treatment only if the entire amount received in the distribution was in fact, rolled over to another eligible retirement plan within 60 days of the date of the distribution.

A lump-sum distribution from a qualified pension, etc., plan or a complete distribution upon termination of such a plan is not includible in a participant's gross income to the extent that the participant makes a rollover contribution to an IRA or to another qualified plan within 60 days of the date of the distribution (sec. 402(a)). If the participant makes a rollover contribution of less than the full amount eligible for rollover treatment, the amount retained is taxed in the year of receipt as ordinary income and is not eligible for special 10-year income averaging.

Thus, while under prior law a participant could take a partial distribution from an IRA and qualify for tax-free rollover treatment only if the entire distribution was rolled over, a participant in a qualified plan who received a total distribution could qualify for tax-free rollover treatment to the extent of any partial rollover.

Reasons for Change

Because prior law did not permit partial rollovers from IRAs, imposition of withholding taxes on IRA distributions could cause the entire distribution to be taxed to the recipient, whether or not any amount were, in fact, rolled over to another eligible retirement plan. Congress concluded that it is appropriate to permit partial rollovers from IRAs to prevent this result.

Explanation of Provision

Under the Act, a distribution from an IRA is not includible in the recipient's gross income to the extent that the recipient makes a rollover contribution to another eligible retirement plan within 60 days after the receipt of the distribution.

If the recipient makes a rollover contribution of less than the full amount of the distribution, the amount retained is taxed in the year of receipt as ordinary income.

Effective Date

The provision applies to distributions made after December 31, 1982.

6. Foreign Transactions

a. Access to records and persons not found in the United States (secs. 336, 337, and 342 of the Act and sec. 7701 and new sec. 982 of the Code)*

Prior Law

Documents held abroad.—Under prior law, an administrative summons could be directed to a U.S. person outside the United States. However, it may not have been enforceable because section 7604 and other operative sections of the Code specifically conferred jurisdiction to enforce the summons on a District Court only when a person resided or was found in a judicial district of the United States. Because a U.S. citizen or resident living abroad may not have resided in or been found in a judicial district of the United States there may have been no district court that could enforce a summons served on such a person.

Under current law, proper service of summons is accomplished only when an attested copy is delivered in hand to the person to whom it is directed, or left at his usual place of abode (sec. 7603). The Commissioner may issue summonses to examine any books, papers, records, or other data that may be relevant or material to a tax inquiry. To enforce an administrative summons, the Commissioner must show that (1) the investigation will be conducted pursuant to a legitimate purpose, (2) the inquiry may be relevant to that purpose, (3) the information sought is not already within his possession, and (4) the administrative steps required by the Code have been followed. To the extent that a summons is overbroad it is invalid, because to that extent the inquiry is irrelevant to a legitimate purpose. In addition, the Secretary must at all times use the summons authority in good faith.

There was, under prior law, generally no procedure to require timely production of documents held abroad.

Treaty benefits.—The Internal Revenue Code generally imposes a 30-percent tax on the gross amount of certain passive income which arises from U.S. sources and is paid to foreign persons. The 30-percent tax on such gross amounts is collected by withholding at the source. The person required to withhold the tax (the "withholding agent") may be the actual payor of the income or certain agents of the payor, such as banks or other financial intermediaries, which have control over, or custody of, such income.

Tax treaties between the United States and other countries commonly provide, on a reciprocal basis, for reduced rates or elimination of U.S. tax on various categories of passive income paid to residents of such other countries. Generally, under current regulations, a foreign recipient of U.S. source passive income may obtain a reduction or elimination of U.S. tax on such income under an applicable treaty if the recipient provides the payor or other person having control of such income with a completed Internal Revenue Service Form 1001. The Form 1001 identifies the owner of the income, states the character of the income, and contains a statement that the recipient qualifies for the relevant treaty benefits.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 372; S. Rep. No. 97-494 (vol. 1) (July 12, 1982), p. 298; and H. Rep No. 97-760 (August 17, 1982), pp. 590-594.

In addition, regulations prescribe an "address method" for obtaining reduced rates of withholding tax for U.S. source dividends paid to foreign persons which is different from the Form 1001 procedure that applies to other types of passive income. Under the address method, a recipient of U.S. source dividends who has an address in a country with which the United States has a tax treaty will, with limited exceptions, be presumed to be a resident of such country for purposes of obtaining reduced rates of tax on dividends under the treaty. The pertinent regulations provide that the withholding agent may withhold on dividends at the reduced treaty rates in reliance upon the foreign address of the recipient unless the agent has knowledge that the recipient is not a resident of the country under whose treaty the reduced rates are claimed.

Reasons for Change

Documents held abroad.—The Congress believed that the Federal courts should be able to enforce a properly served administrative summons on a U.S. citizen or resident abroad.

In addition, the Congress intended to discourage taxpayers from delaying or refusing disclosure of certain foreign based information to the Internal Revenue Service.

Treaty benefits.—The need to limit treaty benefits to those persons who are justifiably entitled to such benefits is particularly acute because of the large number of income tax treaties with low tax bank secrecy jurisdictions. Congress had repeatedly shown its concern about the vulnerability of the treaty system to manipulation. In June of 1982, the Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Government Operations Committee held a hearing on the use of foreign addresses by U.S. individuals to evade tax by posing as nonresident aliens. The Subcommittee on Oversight of the House Committee on Ways and Means held hearings in April 1980 about abuses of income tax treaties and in April 1979 about the abuse of offshore tax havens. These hearings demonstrated that substantial amounts of passive income, which would be tax-free in the hands of foreigners, find their way into the hands of U.S. persons and residents of nontreaty countries who should be paying tax on those amounts. The hearings reflected concern about the use of treaties by those not justifiably entitled to their benefits (so-called "treaty shopping").

The Internal Revenue Service and Treasury believed that the current procedures are insufficient for insuring that U.S. persons do not pose as foreigners entitled to tax treaty benefits and that foreigners do not take advantage of treaties of countries of which they are not resident. The Congress shared these concerns regarding the improper obtaining of treaty benefits and agreed that the current procedures are insufficient. The address system of withholding of tax on U.S. source dividends is particularly vulnerable to abuse. The Form 1001 filing procedure which applies to income other than dividends is similarly subject to abuse in that it requires a person claiming treaty benefits only to submit an unverified, self-serving statement to a withholding agent, who is entitled to rely on that statement for purposes of reducing the amount of tax withheld.

Explanation of Provisions

Documents held abroad.—The Act establishes jurisdiction for summons enforcement actions involving U.S. citizens or residents living abroad in the United States District Court for the District of Columbia. This is accomplished by treating a citizen or resident of the United States who does not reside in any U.S. judicial district, and who is not found in any U.S. judicial district, as residing in the District of Columbia for tax purposes relating to jurisdiction of courts and enforcement of summons.

The Act does not affect the requirements for proper service of a summons. Accordingly, the provisions of prior and present law that require delivery by hand or leaving of the summons at the usual place of abode will have to be complied with (sec. 7603).

In addition, the Act adds a formal document request procedure to the Code. The Act provides that if a taxpayer fails to "substantially comply" with a "formal document request" arising out of an examination of the tax treatment of any item, upon motion of the Secretary, any court having jurisdiction over a civil tax proceeding in which the tax treatment of the examined item is at issue shall prohibit the introduction into evidence by the taxpayer of any "foreign-based documentation" covered by such request. This exclusion from evidence does not apply to any documentation that was provided to the Secretary within 90 days, or a later date set by the Secretary, of the mailing of the request.

Whether a taxpayer has substantially complied with a formal document request will depend on all the facts and circumstances. For instance, if the Internal Revenue Service presents a taxpayer with a formal document request for 10 items and the taxpayer produces 9 of them but fails (without reasonable cause) to produce the one requested document that appears to a court to be the most significant item, a court may decide that there has not been substantial compliance and exclude all of the items. However, when the Service issues multiple requests in the course of an audit, and when, for example, the taxpayer fails to comply with one particular request for only one document, the taxpayer's timely satisfaction of other requests is one factor (but not the only factor) to be considered in determining whether his overall compliance has been substantial. If overall compliance in such a situation has been substantial, the document requested but not supplied could be admissible.

The determination of whether a taxpayer has substantially complied with a formal document request will be made on an issue-by-issue basis. If a taxpayer presented with one or more document requests relating to more than one issue fails substantially to comply as to a document or documents related to one of those issues, that failure to comply will not prevent the introduction of documents related to other issues and supplied by the taxpayer.

The term "foreign-based documentation" means any documentation which is outside the United States and which may be relevant or material to the tax treatment of an examined item. It includes documents held by a foreign entity whether or not controlled by the taxpayer. The term "documentation" includes, but is not limited to, books and records.

The term "formal document request" means any request (made in the course of an audit and after the normal request procedures have failed to produce the requested documentation) for the production of foreign-based documentation which is mailed by registered or certified mail to the taxpayer at his last known address and which sets forth (1) the time and place for the production of the documentation, (2) a statement of the reason the documentation previously produced (if any) is not sufficient, (3) a description of the documentation being sought, and (4) the consequences to the taxpayer of the failure to produce the documentation. The normal request procedures that a formal document request must follow include an information document request. An information document request is the standard Internal Revenue Service request for information that occurs during a routine audit. Congress did not intend that the formal document request procedure be used as the routine beginning of an examination. Congress intended that the Commissioner establish procedures for administrative review of proposed formal document requests before issuance. The Service can require in its request that foreign documents be translated into English.

The sanction of nonadmissibility does not arise if the taxpayer establishes that the failure to provide the documentation as requested by the Secretary is due to reasonable cause. In determining whether there was reasonable cause for failure to produce, a court may take into account whether the request was reasonable in scope, whether the requested documents or copies thereof were available within the United States, and the reasonableness of the requested place of production within the United States.

The fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the requested documentation is not reasonable cause. Frequently, taxpayers choose to operate through a particular country because of its restrictive nondisclosure laws. Even so, the amendment's preclusion of the use of foreign nondisclosure law as a defense is narrow in scope. The only effect of the preclusion is that the taxpayer cannot introduce at trial records that he allegedly could not earlier produce on audit.

Congress recognized that minority status can prevent a taxpayer from being able to produce certain records held by a foreign entity. However, Congress also recognized that taxpayers may seek to hide behind minority status to avoid production of records. Accordingly, a determination of whether minority status is reasonable cause will depend on the facts and circumstances of the case.

Reasonable cause may excuse delay in production. For example, translation of documents into English may not be reasonably possible in 90 days.

Any person to whom a formal document request is mailed has the right to begin a proceeding to quash that request not later than the 90th day after the day such request was mailed. In this proceeding, the taxpayer may contend, for example, that all or part of the documentation requested is not relevant to the tax issue, that the place of requested production within the United States is unreasonable, that the requested documents or copies thereof are available within the United States, or that there is reasonable cause for failure to produce or delay in production.

The reasonableness of a demand for the production of the originals of foreign documents rather than copies may be resolved in judicial proceedings to quash the request. If the foreign country makes it impossible to remove the original documents requested, not because of secrecy laws but, for example, because of foreign tax laws or laws as to the rights of creditors, true copies may be sufficient.

In any proceeding to quash, the Secretary may seek to compel compliance with the request. Jurisdiction over a proceeding to quash is retained in the United States District Court for the district in which the person to whom the formal document request is mailed resides or is found. If that person resides and is found outside the United States, the United States District Court for the District of Columbia has jurisdiction.

In a proceeding to quash, as under the current rules for administrative summonses, the Commissioner has the burden of showing relevance and materiality of the requested records. In addition, the Commissioner must show that the investigation will be conducted pursuant to a legitimate purpose, that the information sought is not already within his possession, and that the administrative steps required by the Code have been followed. During the proceeding, the running of the 90-day period for compliance with a formal document request is suspended. If the district court rules against the taxpayer, the taxpayer may appeal the court's order immediately.

The taxpayer generally has 90 days from the day of mailing to comply with a formal document request. However, the Secretary or a court having jurisdiction over a motion to quash the request may extend the period. The court may extend the period in response to a motion to quash or in response to a motion to extend the period that is not part of a motion to quash. For example, a court could find that a taxpayer had reasonable cause for failure to produce an item within 90 days and set a later date for production.

Treaty benefits.—The Act requires the Secretary to establish procedures to limit treaty benefits to those persons who are entitled to such benefits. For this purpose, persons who are entitled to treaty benefits do not include U.S. persons posing as foreigners or foreign persons who unjustifiably use tax treaties of countries of which they are not resident. Thus, the procedures are to be designed to prevent the kind of abuse that occurs through the improper use of nominees and other conduits that pass U.S. source income through to a third party who is not a resident of the treaty country.

A number of alternatives to the present enforcement system exist, including the adoption of a refund system of withholding tax on passive income. A refund system would require withholding agents to withhold U.S. tax at the statutory 30-percent rate on all

U.S. source passive income paid to foreign persons, regardless of the potential application of a treaty provision reducing the 30-percent rate or eliminating the tax altogether. The foreign recipient who claims treaty benefits would then be required to file a claim for a refund on an annual tax return. Supportive documentation would be required.

Another approach, the "certification system," would require the foreign recipient to file a certificate of residence from the competent authority of the country whose treaty benefits are being sought.

The Act requires the Secretary to consider the refund system and the certification system as methods of limiting treaty benefits to those persons entitled to them. The Secretary is not limited to consideration of these methods; he is to consider other methods as well. In developing procedures to prevent abuse the Secretary is to consider the extent to which any procedures would prevent abuse, the administrability of such procedures (including the ability of U.S. treaty partners to provide cooperation), any negative effect on investment in the United States by foreign persons which could be caused by increased costs of complying with the procedures, and the effect on U.S. investment abroad should U.S. treaty partners apply a similar method to that utilized by the United States. The Secretary may thus apply different procedures for different treaties, for different kinds of income, and so forth.

The provision requires the Secretary to establish procedures, as described above, within two years after the date of enactment, that is, by September 3, 1984.

Effective Dates

The provision treating certain U.S. citizens or residents as residing in the District of Columbia became effective September 4, 1982, the day after the date of enactment. The provision adding a formal document request procedure applies to formal document requests mailed after September 3, 1982, the date of enactment.

b. Penalty for failure to furnish information returns with respect to certain foreign corporations; reporting requirement for corporations controlled by foreign persons (secs. 338 and 339 of the Act and sec. 6038 and new sec. 6038A of the Code)*

Prior Law

A U.S. person who controls a foreign corporation is required to furnish the Internal Revenue Service with certain information concerning the corporation (section 6038(a)). The Secretary is authorized to prescribe regulations setting forth the specific information to be furnished. Under prior law, the sole civil penalty for failure to furnish any required information was a 10-percent reduction of the U.S. person's creditable foreign taxes. Under this penalty, additional five percent reductions are provided if the failure to furnish information continues 90 days or more after notice to the U.S.

---

*For legislative background of the provisions, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 373; S. Rep. No. 97-494 (vol. 1) (July 12, 1982), pp. 299-300; and H. Rep. No. 97-760 (August 17, 1982), pp. 589-590.

person required to provide the information. In such a case, creditable foreign taxes may be reduced by 5 percent for each 3-month period or fraction thereof during which the failure continues. In no event, however, can this penalty for a failure to furnish information exceed the greater of $10,000 or the foreign corporation's income for the tax year with respect to which the failure occurs. This penalty does not apply if it is shown to the satifaction of the Secretary that reasonable cause exists for failure to furnish the required information on time.

There was no specific statutory reporting requirement for a U.S. corporation (or a foreign corporation operating in the United States) that was controlled by a foreign person and that entered into transactions with related parties.

Reasons for Change

Despite concern about inadequate reporting with respect to controlled foreign corporations, penalties generally were not imposed (sec. 6038(b)). In part, this was because the penalty is complicated. It also may be unduly harsh in some cases, because a taxpayer can incur a substantial penalty for a minor failure. On the other hand, a sanction reducing creditable foreign taxes is of no use if the U.S. person required to report paid no foreign income taxes during the year in question.

Transactions between related parties are required to be at arms length prices. This rule applies, for example, to transactions between a U.S. parent and its foreign subsidiaries as well as to transactions between a foreign parent and its U.S. subsidiaries. Under prior law, a U.S. parent corporation was required to report transactions with its foreign affiliates and transactions between its foreign affiliates, but no such reporting was required of transactions between a U.S. subsidiary of a foreign corporation and its foreign affiliates. Consequently, the existence of such transactions did not necessarily come to the attention of the Internal Revenue Service. Congress believed that a requirement that such transactions be reported will reduce transfer price abuses and similar abuses and will place foreign controlled U.S. entities on an equal footing with U.S. corporations controlled by U.S. persons.

Explanation of Provisions

The Act adds a fixed-dollar penalty for failure to furnish the Internal Revenue Service the information required by section 6038 of the Code. The penalty is $1,000 for each failure to furnish information for an annual accounting period (generally a taxable year) of the foreign corporation. If the failure continues for more than 90 days after notification by the Secretary, then there are additional $1,000 penalties for each 30-day period (or fraction thereof) during which the taxpayer continues to fail to produce the requested information. In no event, however, can failure to furnish information for any one annual accounting period of any one foreign corporation cause accumulated $1,000 penalties to exceed $25,000. As under prior law, so long as it is shown to the satisfaction of the Secretary that reasonable cause for the failure exists, no penalty is due.

The Act retains the potentially significant penalty of a reduction in foreign tax credit to be imposed when the Internal Revenue Service considers it appropriate. When both penalties are applied, the amount of the reduction in the foreign tax credit is reduced by the amount of the fixed-dollar penalty imposed. It was intended that the reduction in foreign tax credit penalty could be waived in some cases in which the flat $1,000 penalty will be imposed.

Congress intended that there be no change in the prior law substantive reporting requirements.

The Act also adds a new reporting requirement for certain foreign-controlled corporations. In general, these requirements apply both to U.S. corporations and to foreign corporations engaged in trade or business in the United States ("reporting corporations"), but only if they are controlled by a foreign person (defined to include certain possessions residents). This control test requires reporting if at any time during a taxable year a foreign person owns 50 percent or more of the stock of the reporting corporation (either by value or by voting power).

The reporting corporation must furnish certain information about any corporation that (1) is a member of the same "controlled group" as the reporting corporation (a group that generally includes brother-sister corporations as well as the reporting corporation's parent and subsidiaries) [1] and that (2) has any transaction with the reporting corporation during the taxable year. The information that the reporting company is to report is such information as the Secretary may require that relates to the related company's name, its principal place of business, the nature of its business, the country in which it is organized and in which it is resident, its relationship with the reporting corporation, and its transactions with the reporting corporation during the year.

The Act imposes penalties for violation of this new reporting requirement that are similar to the new supplemental penalties for failure to supply information under the reporting requirement relating to controlled foreign corporations. Reasonable cause, as shown to the satisfaction of the Secretary, precludes imposition of this penalty.

Effective Dates

The supplemental fixed-dollar penalty for failure to furnish information with respect to certain foreign corporations controlled by U.S. persons is effective for annual accounting periods ending after the date of enactment. The new reporting requirement for corporations controlled by foreign persons applies to taxable years beginning after December 31, 1982.

---

[1] For the purpose of the new provision, the term "controlled group" incorporates the definition of controlled group of corporations in sec. 1563(a) with certain changes in the percentage tests of that section and with certain exceptions.

Although under sec. 1563(b) foreign corporations subject to tax under sec. 881 and certain other corporations are "excluded members" of a controlled group rather than "component members" for the purpose of sec. 1561, the exclusion of these corporations from the definition of "component members" for that purpose does not remove them from the controlled group, as defined in sec. 1563(a). Therefore, the Act requires reporting about any foreign corporation that otherwise qualifies as a member of the controlled group.

c. Returns with respect to foreign personal holding companies (sec. 340 of the Act and secs. 6035 and 6679 of the Code)*

Prior Law

Each person who was an officer or director of a foreign personal holding company, and each 50-percent or greater U.S. shareholder of a foreign personal holding company, was required to file certain reports with respect to that corporation (section 6035). Both monthly reports of stockholdings and annual reports of income were required. The monthly report of stockholdings in the corporation was due on the 15th day of each month for which a report was required, but the Secretary was authorized to delay the filing of this report to a due date that was the 15th day of a later month. By regulations the Secretary had delayed the filing date until after the close of the foreign corporation's taxable year. The report of the income of the foreign corporation had to be filed within 60 days after the close of the taxable year of the foreign personal holding company to which it related.

Prior law provided only a criminal penalty for violation of these reporting requirements.

Reasons for Change

The Internal Revenue Service requires persons engaging in international transactions, and persons who transfer assets to foreign entities, to file a number of different forms. Often, a person may have to file more than one form covering the same foreign entity for the year. The Internal Revenue Service wanted to combine a number of forms related to international transactions into one and generally require that it be filed after the close of the filer's taxable year. However, the filing dates tied to the date of a transaction for certain reports, as well as the filing dates for reporting relating to foreign personal holding companies, made it impossible for these forms to be combined.

The Internal Revenue Service was concerned that prior application of reporting requirements to shareholders only when they owned (directly or through attribution) 50 percent or more of the corporation created an unintended loophole in the reporting requirements. Foreign personal holding company income is subject to U.S. tax when five or fewer U.S. individuals own more than half the corporation's stock (sec. 552(a)(2)). Shareholder reporting requirements needed to conform more closely to underlying tax liability. The reporting required of U.S. officers and directors (as opposed to shareholders) did not cure this problem, because controlling U.S. shareholders could arrange for foreigners to serve as officers and directors.

Prior law omitted a civil penalty for violation of these requirements. In some respects, too, the reporting requirements of prior law were inadequate (as to ownership of options and as to the nature of classes of stock). Moreover, prior law omitted a reporting requirement when the circumstances triggering the filing requirement no longer existed by the filing date.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 374; S. Rep. No. 97-494 (vol. 1) (July 12, 1982), pp. 301-302; and H. Rep. No. 97-760 (August 17, 1982), pp. 588-589.

Explanation of Provision

The Act replaces the prior foreign personal holding company reporting requirements. The Act imposes its reporting requirements on 10-percent (rather than 50-percent) shareholders of a foreign personal holding company as well as on officers and directors. The calculation of whether a person is a 10-percent shareholder involves indirect ownership as well as direct ownership.

The required information includes both shareholder information and income information as well as such other necessary information as the Secretary shall prescribe. Required shareholder information includes the names and addresses of all persons who held shares, options, and convertible securities during the taxable year; a description of each class of shares and the total number of shares of each class outstanding at year's end; the number of shares of each class, options, or convertible securities held by each person; and any changes in the holdings of shares, options, or convertible securities during the year. Required income information includes the foreign personal holding company's gross income, deductions, credits, taxable income, and undistributed foreign personal holding company income for the year.

The Act changes prior law to give the Internal Revenue Service more flexibility in establishing filing dates for reports relating to foreign personal holding companies and to make it possible for the Internal Revenue Service to include the foreign personal holding company reports in a combined international report. In particular, it authorizes the Commissioner to designate the time when the foreign personal holding company reports and returns must be filed.

Whether a person is required to file a return is determined on the date the return is due. If, on that date, no person is required to file (because, for example, the corporation has been dissolved), then filing is required of the persons who were officers, directors or 10-percent shareholders on the last day of the corporation's taxable year for which there was a person required to file.

If two or more persons are required to file, the Act provides that the Secretary may, by regulations, require only one of them to file.

The Act also adds a $1,000 civil penalty for failure to file a proper foreign personal holding company information return. This penalty does not apply, however, if the failure is shown to be due to reasonable cause.

Effective Date

This provision applies to taxable years of foreign corporations beginning after the date of enactment, September 3, 1982.

d. Authority to delay date for filing certain returns relating to foreign corporations and foreign trusts (sec. 341 of the act and secs. 6046 and 6048 of the Code)*

Prior Law

Under prior law and under present law, a return has to be filed by U.S. persons who become officers or directors of a foreign corporation and by U.S. persons who acquire at least a 5-percent interest (or an additional 5-percent interest) in a foreign corporation (sec. 6046). Under prior law, the return had to be filed within 90 days of the event that triggered the duty to file.

A return also has to be filed by certain U.S. persons transferring property to a foreign trust (sec. 6048). The return had to be filed within 90 days of the triggering event, in this case creation of the trust or a transfer to the trust.

Reasons for Change

As described under the explanation of the foreign personal holding company reporting requirements (section 340 of the Act), the Internal Revenue Service was considering consolidating a number of international reporting forms. The specific reporting dates tied to a triggering event, rather than a taxable year, made it impossible to include these reports relating to foreign corporations and trusts in the combined report.

Explanation of Provision

The Act authorizes the Secretary to delay the reporting of transactions covered by section 6046 (foreign corporations) and section 6048 (foreign trusts) until some date after the 90th day after the transaction that must be reported.

Effective Date

The provision applies to returns filed after the date of enactment, September 3, 1982.

e. Technical amendment to section 905(c) (sec. 343 of the Act and sec. 905 of the Code)**

Prior Law

If a foreign tax for which a U.S. foreign tax credit was taken is refunded the taxpayer must notify the Secretary of the refund (section 905(c)). The Secretary then redetermines the taxpayer's tax and notifies the taxpayer of the amount due. Interest on any additional tax does not begin to run until the taxpayer receives the refund of the foreign tax. This rule is in contrast to the general rule for payment of interest which is that interest is imposed on any amount of tax that is due but not paid on the last date prescribed for payment (section 6601).

---

*For legislative background of the provision, see H.R. 4961, as reported by the Senate Finance Committee, sec. 375; S. Rep. No. 97-494 (vol. 1) (July 12, 1982), p. 303; and H. Rep. No. 97-760 (August 17, 1982), pp. 594-595.

**For legislative background of the provision, see H.R. 4961, as reported by the Senate Finance Committee, sec. 376; S. Rep. No. 97-494 (vol. 1) (July 12, 1982), p. 304; and H. Rep. No. 97-760 (August 17, 1982), p. 595.

Section 2(c)(1) of Public Law 96-603 added a sentence to section 905(c) that appeared to provide that if a taxpayer did not notify the Commissioner of an adjustment in foreign taxes then interest on an underpayment of tax caused by an adjustment of the taxpayer's foreign taxes paid began to run from some point in time before the taxpayer received the refund of the foreign tax. This provision was intended to penalize a taxpayer for failing to notify the Commmissioner of a refund of foreign taxes.

Reasons for Change

The last sentence of section 905(c) was ambiguous. It was also unnecessary because the same Act that added it also added a penalty to the Code (section 6689) for failure to report a redetermination of foreign tax.

Explanation of Provision

The Act repeals the last sentence of section 905(c).

Effective Date

This provision is effective for all years.

7. Interest Provisions

a. Daily compounding of interest (sec. 344 of the Act and new sec. 6622 of the Code)*

Prior Law

Under prior law, interest payable to or by the United States under the internal revenue laws was not compounded. Thus, annual interest was payable only on the principal amount of an obligation (for example, an underpayment) and not on any accrued interest component thereof.

Reasons for Change

Failure to compound interest owing under the Internal Revenue Code significantly reduced the effective rate of interest provided for under the internal revenue laws. As a result, neither the United States nor taxpayers were adequately compensated for the value of money owing to them under the tax laws. This undercompensation was magnified the longer the debt was outstanding. For example, at a 15-percent interest rate the satisfaction of a $100 obligation after 5 years would require $211.67 if interest were compounded daily but only $175 if interest is not compounded. In addition, the cost of allowing the obligation to remain unpaid a sixth year would be $15 under a simple interest system and $34.24 if interest is compounded daily. Congress believed that the understatement of economic interest could induce some taxpayers to delay resolution of tax controversies, thus putting an unreasonable burden on the Internal Revenue Service.

Explanation of Provision

Under the Act, all interest payable under the internal revenue laws will be compounded daily. This adjustment will conform computation of interest under the internal revenue laws to commercial practice. Except in the case of the penalty for failure to pay estimated taxes, daily compounding is required for any other amounts computed by reference to the interest rate provided for in the Code. In a case in which the principal portion of an obligation is satisfied, and interest remains outstanding, such interest will be compounded.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 381; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), p. 305; and H. Rep. No. 97-760 (August 17, 1982), pp. 595-596 (Joint Explanatory Statement of the Committee of Conference).

Effective Date

This compounding requirement applies in determining interest after December 31, 1982 on any amount, whether principal or interest, owing on or after January 1, 1983.

b. Semi-annual determination of rate of interest (sec. 345 of the Act and sec. 6621 of the Code)*

Prior Law

Under prior law, the rate of interest paid on underpayments, overpayments, and for certain other purposes under the internal revenue laws, was established by the Treasury no later than October 15 of any year. The interest rate was based on the average predominant prime rate (the rate quoted by commercial banks to their preferred customers for short-term loans) during September of that year rounded to the nearest full percentage point. The new rate became effective January 1 of the following year (except that in 1982 it became effective on February 1). Thus, the rate of interest was determined once a year based on September's average predominant prime rate.

Reasons for Change

Congress believed that because of dramatic monthly fluctuations in interest rates between months, a longer base period for establishing the rate and more frequent adjustments were needed to reflect accurately the cost of borrowing money during the year and to prevent a wide divergence between the statutory rate and the actual market rate of interest.

Explanation of Provision

Under the Act, interest rates are redetermined twice a year on the basis of the average adjusted prime rate charged by commercial banks during the six-month period ending September 30 (effective January 1 of the succeeding calendar year), and March 31 (effective July 1 of the same calendar year).

Effective Date

The amendment is effective for adjustments taking effect on January 1, 1983, and thereafter. Thus, the first adjustment will be based on the adjusted prime rate for April through September 1982 and will take effect in January 1, 1983.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 382; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), p. 306; and H. Rep. No. 97-760 (August 17, 1982), p. 596 (Joint Explanatory Statement of the Committee of Conference).

c. Restrictions on payment of interest for certain periods (sec. 346 of the Act and secs. 6601 and 6611 of the Code)**

Prior Law

In general, under prior law, interest on refunds, credits and offsets ran from the date of overpayment, which was usually the date prescribed for filing the particular return, to a date (in the case of a refund) preceding the date of the refund check by not more than 30 days, or (in the case of a credit) to the due date of the amount against which the credit was taken. Further, if an overpayment of income tax was refunded within 45 days after the last date prescribed for filing the return (without extensions) or, if later, within 45 days after the date the return was filed, no interest was payable on the overpayment. Under prior law, an overpayment resulting from a net operating loss carryback, net capital loss carryback, or credit carryback was treated as having occurred at the close of the year in which the carryback arose. In the case of any overpayment of tax resulting from the carryback of taxes paid or accrued to a foreign country or U.S. possession, such overpayment was deemed not to have been paid or accrued prior to the close of the taxable year of the taxpayer in which such amounts were actually paid or accrued.

In the case of an underpayment of tax, interest runs from the last date prescribed for payment of the tax (usually the return due date) without regard to extensions, to the date the tax is paid. If the last date for payment is not otherwise prescribed, it is deemed to be the date liability for the tax arises (but in no case later than the date the Secretary makes notice and demand for the tax). If there was an underpayment of tax for any taxable year, and the amount of the underpayment was reduced by reason of the carryback of a net operating loss, net capital loss, or because of the increase in any credit for the taxable year due to a credit carryback from another taxable year, such reduction in the amount of the prior year's underpayment did not reduce the amount on which interest was payable prior to the last day of the taxable year in which the net operating loss, the net capital loss, or credit carryback arose.

Reasons for Change

Congress believed that it was inappropriate to require the U.S. to pay interest on amounts which taxpayers failed to claim in a timely manner. In particular, Congress believed that interest should not be paid on underpayments when the taxpayer has failed to file a timely return or has filed a return that cannot be processed. In the case of refunds arising from net operating loss and credit carrybacks, Congress believed that no interest should be paid on the refund prior to the time it is actually claimed.

**For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 383; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 307-308; and H. Rep. No. 97-760 (August 17, 1982), pp. 596-597 (Joint Explanation Statement of the Committee of Conference).

Explanation of Provision

Under the Act, the general rule with respect to the payment of interest on overpayments is unchanged when the credit or refund is claimed in a timely filed return. However, when the return is late because it is filed after the due date (determined with regard to extensions) no interest is payable on the overpayment for any period prior to the date on which the return is filed. For this purpose, and for purposes of determining whether a refund has been made within 45 days after the return is filed, no return is treated as filed until filed in processible form. The return is in "processible form" if it is on a permitted form; contains sufficient taxpayer identifying information and signatures; and sufficient information to permit the Secretary to verify mathematically the amount of tax liability shown on the return.

Under the Act, the rules relating to interest on payments attributable to net operating loss carrybacks and credit carrybacks are modified to provide that interest generally will run from the due date of the return for the year in which the loss or credit carryback arises rather than from the close of such year.

If, however, the claim for refund (including an application for tentative carryback or refund adjustment) based on the carryback of the loss or credit from the loss year is filed after the due date of the return for the loss year (determined without regard to extensions), the Act provides that interest on the refund is payable only if the refund is not made within 45 days of the claim. If the 45-day period expires, interest runs from the due date of the return for the loss year. If the overpayment attributable to a carryback gives rise to a credit or offset (as in an inter-year adjustment made during an audit) then interest runs on the portion of the overpayment in excess of the amount credited or offset from the due date of the return for the loss year. Similarly, interest on the underpayment so credited or offset against will cease to accrue as of the filing date for the loss year. Conforming changes are made in the rules relating to interest on underpayments reduced by carrybacks. Instead of reducing the amount of the underpayment for interest computation purposes as of the close of the loss year, the underpayment is reduced as of the original due date (without extensions) of the return for the loss year (the "filing date").

Effective Date

These amendments apply to interest accruing after October 3, 1982. Thus, if a taxpayer files a refund claim ,including an application for tentative refund based on the carryback of a 1981 net operating loss on December 1, 1982, interest will run from January 1, 1982, through October 3, 1982, under the rules of prior law. If the refund is issued within 45 days, no other interest will be paid. If the 45-day period lapses, interest will be paid for the period after October 3, 1982.

8. Taxpayer Safeguard Provisions (Secs. 347-350 of the Act and Secs. 6334, 6325, 6331, 6337, and 7426 of the Code)*

Prior Law

Property exempt from levy

Present law (and prior law) exempts certain property from levy. Among other items, this exemption covers (1) fuel, provisions, furniture, and personal effects; (2) books and tools of a trade, business or profession; and (3) wages, salary, or other income.

For a taxpayer who is the head of a family, there was a $500 exemption for fuel, provisions, furniture, and personal effects in his household, and for arms for personal use, livestock, and poultry.

Books and tools necessary for the trade, business, or profession of the taxpayer were exempt from levy to the extent that they did not exceed $250 in aggregate value.

The exemption for wages, salary, and other income was $50 per week plus $15 per week with respect to each individual over half of whose support is received from the taxpayer, who is the spouse of the taxpayer, who is a dependent of the taxpayer, and who is not a minor child of the taxpayer with respect to whom amounts are exempt from levy pursuant to a support judgment entered prior to the date of levy.

Release of lien

Under present law (and prior law), a lien may be released if the tax liability has been fully satisfied or has become legally unenforceable; or upon acceptance of a bond that is conditioned upon the payment of the amount assessed, together with all interest. Under prior law, there was no statutory time limit for the release of a lien.

Notice before levy

Levy upon property may be made if the taxpayer neglects or refuses to pay tax within 10 days after notice and demand. In the case of a levy upon property, other than salary or wages, there was no statutory provision, under prior law, that required notice before levy.

Levy may be made upon the salary or wages of a taxpayer only after the Secretary has notified the taxpayer in writing of his intention to make such levy, unless there has been a finding that the collection of tax is in jeopardy. This notice must be given in person, left at the taxpayer's dwelling or usual place of business, or sent by mail to the taxpayer's last known address, no less than 10 days before the day of levy.

---

*For legislative background of the provison, see: H. Rep. No. 97-760 (August 17, 1982), pp. 614-616 (Joint Explanatory Statement of the Committee of Conference).

A levy on salary or wages is continuous from the date it is made until the taxpayer's liability is satisfied or becomes unenforceable due to lapse of time. Once the tax liability is satisfied or becomes unenforceable, the Secretary is required promptly to release the levy and notify the taxpayer of such action.

Redemption of property

Under prior law, the owners of real property that was sold after a seizure, their heirs, executors, or administrators, or any person having an interest therein, or a lien thereon, or any person in their behalf, could redeem the property at any time within 120 days after the sale.

Amount of damages in case of wrongful levy

In the case of an alleged wrongful levy, a person (other than the person against whom is assessed the tax out of which such levy arose) who claims an interest in, or lien on, the property levied upon may bring a civil action against the United States in a U.S. district court. Under prior law, if the court determined there was a wrongful levy, then the court could (1) order the return of the property if the United States was in possession thereof; (2) grant a judgment for the amount of money levied upon; or (3) grant a judgment for an amount not exceeding the amount received by the United States from the sale of property.

Reasons for Change

Congress was concerned that taxpayers sometimes were forced to undergo substantial hardships once collection procedures have been instituted by the Internal Revenue Service. Thus, Congress reviewed several provisions of prior law to determine where changes were necessary to increase the protections available to taxpayers. Where appropriate, changes were made to provide additional safeguards without reducing the ability of the Internal Revenue Service to administer the internal revenue laws and to collect taxes.

First, in recognition of the hardships faced by taxpayers during the collection process, Congress increased the dollar amounts of items of a taxpayer's property that are exempt from levy. Second, Congress imposed a statutory time limit with respect to when a lien against property must be released. Third, the law was amended to provide a taxpayer with written notice before a levy upon property. Fourth, the period of time for redeeming real property that has been sold after being seized has been extended. Finally, in the case of a wrongful sale of property by the United States, a third party will be allowed to recover an amount not exceeding the fair market value of the property immediately before levy.

Explanation of Provision

Property exempt from levy

The Act increases the exemption from levy for (1) fuel, provisions, furniture, and personal effects, etc.; (2) books and tools of a trade, business, or profession; and (3) wages, salary, or other income.

The exemption for fuel, provisions, furniture, and personal effects, etc., is increased from $500 to $1,500.

The exemption for books and tools of a trade, business, or profession is increased from $250 to $1,000.

The exemption for wages, salary, and other income is increased to $75 per week plus $25 per week for the taxpayer's spouse and each dependent.

Release of lien

The Act requires a lien to be released no later than 30 days after the day on which: (1) the tax liability has been fully satisfied or has become legally unenforceable, or (2) a bond has been accepted.

Notice before levy

The Act provides that levy may be made upon the salary, wages, or other property of any person with respect to any unpaid tax only after the Secretary has notified the person in writing of his intention to make such levy. This notice must be given in person, left at the dwelling or usual place of business of such person, or sent by certified or registered mail to such person's last known address, no less than 10 days before the day of levy. As under prior law, a single notice will be sufficient to cover all property of the taxpayer subject to levy.

As under prior law, the notice requirement will not apply to a levy if the Secretary has made a finding that the collection of tax is in jeopardy. Moreover, the Act makes no change with respect to the continuous nature of a levy upon salary or wages, or the requirements with respect to release of the levy and notice of release.

Redemption of property

The Act extends the period of time during which property that has been sold after a seizure may be redeemed from 120 days to 180 days.

Amount of damages in case of wrongful levy

The Act provides that if there has been a wrongful levy and sale of property (belonging to a person other than the person against whom the tax was assessed), then the court may grant a judgment for an amount not exceeding the greater of (1) the amount received by the United States from the sale of such property, or (2) the fair market value of the property immediately before the levy.

Notice of procedural safeguards

Congress was concerned that in certain cases taxpayers may not be aware of the existing statutory or administrative rights and procedural safeguards that are available to them. The distribution of information concerning taxpayer rights at the time of the I.R.S. initial contact with the taxpayer regarding an audit and at appropriate stages during examination and collection proceedings will assure that more taxpayers are adequately apprised of their rights and the procedures available to them. Thus, Congress requested that the Internal Revenue Service consider the sufficiency and timeliness of information sent to taxpayers regarding their rights during examination, appeals, and collection. The results of this study are to be reported to the House Committee on Ways and Means and the Senate Committee on Finance.

Effective Date

The provision increasing the dollar amounts of property exempt from levy applies to levies made after December 31, 1982.

The provision relating to the release of liens is effective with respect to liens (1) which are filed after December 31, 1982, (2) which are satisfied after December 31, 1982, or (3) with respect to which the taxpayer after December 31, 1982, requests the Secretary to issue a certificate of release on the grounds that the liability was satisfied or legally unenforceable.

The provision relating to notice before levy applies to levies made after December 31, 1982.

The provision relating to the period of time for redeeming real property applies to property sold after the date of enactment.

The provision increasing damages for wrongful levies applies to levies made after December 31, 1982.

9. Other Provisions

a. Disallowance of deductions relating to narcotics trafficking (sec. 351 of the Act and new sec. 280E of the Code)*

Prior Law

Ordinary and necessary trade or business expenses are generally deductible in computing taxable income. A recent U.S. Tax Court case allowed deductions for telephone, auto, and rental expenses incurred in the illegal drug trade. In that case, the Internal Revenue Service challenged the amount of the taxpayer's deduction for cost of goods (illegal drugs) sold, but did not challenge the principle that such amounts were deductible.

On public policy grounds, the Code makes certain otherwise ordinary and necessary expenses incurred in a trade or business nondeductible in computing taxable income. These nondeductible expenses include fines, illegal bribes and kickbacks, and certain other illegal payments.

Reasons for Change

There is a sharply defined public policy against drug dealing. To allow drug dealers the benefit of business expense deductions at the same time that the U.S. and its citizens are losing billions of dollars per year to such persons is not compelled by the fact that such deductions are allowed to other, legal enterprises. Congress believed that such deductions must be disallowed on public policy grounds.

Explanation of Provision

All deductions and credits for amounts paid or incurred in the illegal trafficking in drugs listed in the Controlled Substances Act are disallowed. To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to costs of goods sold is not affected by this provision of the Act.

Effective Date

The provision applies to amounts paid or incurred after the date of enactment in taxable years ending after that date.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 391; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), p. 309; and H. Rep. No. 97-760 (August 17, 1982), pp. 597-598 (Joint Explanatory Statement of the Committee of Conference).

b. Report on forms (sec. 353 of the Act)*

This provision of the Act requires the Secretary to study and report to Congress, no later than June 30, 1983, on methods of modifying the design of the forms used by the Internal Revenue Service to achieve greater accuracy in the reporting of income and the matching of information reports and returns with the actual income tax returns.

c. Internal Revenue Service staff increases (sec. 352 of the Act)**

Prior Law

Public Law 97-92 (the third continuing resolution for fiscal year 1982) enabled the Internal Revenue Service to maintain an average of 85,363 positions during fiscal year 1982. Of this total number of positions, 14,556 are in the investigation and collection functions, 27,882 are in the examination functions, and 1,833 are in the appeals functions. The following table sets forth average employee levels in these three functions and in the entire IRS for fiscal year 1982 and the preceding three years:

	Number of positions			
	1979	1980	1981	1982
Function:				
Investigation and collection	11,753	12,802	13,185	14,556
Examination of deficient returns	27,747	28,370	27,402	27,882
Appeals	1,628	1,884	1,858	1,833
Other	45,040	44,408	43,711	41,092
Total IRS employment	86,168	87,464	86,156	85,363

The Administration's budget request for fiscal year 1983 included a net average increase in Internal Revenue Service manpower of 3,310 positions. Included in this request was a 5,225 increase in the number of employees committed to collection of delinquent taxes, identification of nonfilers, examination of deficient returns and appeals. The additional employees are to be distributed within the Internal Revenue Service in the following way:

	New positions
Function:	
Collection of delinquent accounts	3,000
Identification of nonfilers	1,000

---

*For legislative background of the provision, see H.R. 4961, as reported by the Senate Finance Committee, sec. 393; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), p. 309, and H. Rep. No. 97-760 (August 17, 1982), p. 598 (Joint Explanatory Statement of the Committee of Conference).

**For legislative background of the provision, see H.R. 4961, as reported by the Senate Finance Committee, sec. 392; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 310; and H. Rep. No. 97-760 (August 17, 1982), pp. 598 (Joint Explanatory Statement of the Committee of Conference).

Examination of deficient returns	1,000
Appeals	225
Total	5,225

Reasons for Change

Congress believed that adequate staffing for the Internal Revenue Service is essential to achieve better compliance with the internal revenue laws.

Explanation of Provision

The Act contains a sense of Congress resolution that additional funds be appropriated to the Internal Revenue Service to provide additional staff over that requested by the Administration sufficient to collect additional tax revenues of at least $1 billion in fiscal year 1984 and $2 billion in fiscal year 1985.

10. Tax Treatment of Partnership Items (Secs. 401, 402, 403, 404, and 405 of the Act and Secs. 6031, 6046A and 6221 through 6232 of the Code)*

Prior Law

For income tax purposes, partnerships are not taxable entities. Instead, a partnership is a conduit, in which the items of partnership income, deduction, and credit are allocated among the partners for inclusion in their respective income tax returns.

Partnerships are required to file an annual information return setting forth the partnership income, deductions, and credits, names and addresses of the partners, each partner's distributive share of these items, and certain other information required by the regulations. A penalty is imposed on the partnership for each month (not to exceed 5 months), that a partnership return is late or incomplete. The amount of penalty for each month is $50 multiplied by the total number of partners in the partnership during the partnership's taxable year.

Since a partnership is a conduit rather than a taxable entity, adjustments in tax liability may not be made at the partnership level. Rather, under prior law adjustments were made to each partner's income tax return at the time that return was audited. A settlement agreed to by one partner with the Internal Revenue Service was not binding on any other partner or on the Service in dealing with other partners. Similarly, a judicial determination of an issue relating to a partnership item generally was conclusive only as to those partners who were parties to the proceeding.

The Code provides a period of limitations during which the IRS can assess a tax or a taxpayer may file a claim for refund. Generally, the period is 3 years from the date the tax return is filed (if filed before the due date, the due date is treated as the date filed). If more than 25 percent of the gross income is omitted from a return, the statutory period for assessment is 6 years. In the case of a partnership, the income tax return of each of the partners under prior law began that individual partner's period of limitations. Except in the case of Federally registered partnerships, the date of filing of the partnership return did not affect the individual partner's period of limitations. In order to extend the period of limitations with respect to partnership items, the IRS was required to obtain a consent for extension of the statute of limitations from each of the partners—not the partnership. Generally, an agreement to extend the period of limitations related to all items on the return of the partner who consented to the extension.

---

*For legislative background of the provision, see H. Rep. No. 97-76 (August 17, 1982), pp. 599-613. (Joint Explanatory Statement of the Committee of Conference).

There was no partnership return filing requirement for certain foreign based partnerships with U.S. partners in some cases under prior law. There was no express requirement that a U.S. person report the acquisition or disposition of an interest in a foreign partnership.

Windfall profit tax.—Taxable crude oil which would otherwise be treated as produced by a partnership, is allocated among the partners of the partnership according to their income interest. Each partner to whom crude oil is allocated under this rule is treated as the producer of such crude oil. Since each partner is treated as the producer of an allocable share of the partnership's production of crude oil, the partnership must report sufficient details to permit its partners to compute their allocable share of the windfall profit tax on the partnership's crude oil production. In addition, each partner generally will certify his status to the partnership when such status is relevant to any special tax treatment, such as lower rates for independent producers or an exemption based upon the identity of the producer, so that first purchasers can compute the proper withholding of windfall profit taxes.

Reasons for Change

Determination of the tax liability of partners resulted in administrative problems under prior law due to the fragmented nature of such determinations. These problems became excessively burdensome as partnership syndications have developed and grown in recent years.

Large partnerships with partners in many audit jurisdictions result in the statute of limitations expiring with respect to some partners while other partners are required to pay additional taxes. Where there are tiered partnerships, identifying the taxpayer is difficult.

Duplication of manpower and administrative and judicial effort was required in some cases to determine the aggregate tax liability attributable to a single partnership item. Inconsistent results could be obtained for different partners with respect to the same item.

Unless a settlement could be obtained that resolved partnership issues uniformly for all partners in a partnership, settlements were difficult to reach. The Internal Revenue Service had little incentive to settle with one partner where the issue had to be litigated with respect to other partners.

Prior law was inadequate as applied to foreign partnerships with U.S. partners in that partnership return filing requirements were generally not applicable and partnership records kept outside the United States often could not be reached.

Explanation of Provisions

Overview

Under the Act, the tax treatment of partnership items will be determined at the partnership level in a unified partnership proceeding rather than in separate proceedings with the partners.

Except as otherwise provided in subchapter C of Chapter 63 as added by the Act, the tax treatment of any partnership item is to be determined at the partnership level. New rules are adopted which govern the determination of the treatment of partnership items and resulting adjustments, both at the administrative and judicial levels.

Administrative proceedings

Consistency requirement

Under the Act, each partner is required to treat partnership items on his return consistently with the treatment on the partnership return. Where treatment is, or may be, inconsistent (or no partnership return is filed), the consistency requirement is waived if a statement is filed by the partner identifying the inconsistency. Similarly, the consistency requirement may be waived at the partner's election if the partner establishes to the satisfaction of the Secretary that the return treatment of an item was consistent with an incorrect schedule furnished the partner by the partnership.

Failure to satisfy the consistency requirement, if not waived, will result in an adjustment to conform the treatment of the item by the partner with its treatment on the partnership return. Any additional tax resulting from such computational adjustment will be assessed without either the commencement of a partnership proceeding or notification to the partner that the inconsistent item will be treated as a nonpartnership item.

Notice requirements

Each partner whose name and address is furnished to the Secretary will receive notice of the commencement of a partnership level audit as well as notice of the final partnership administrative adjustment (FPAA), provided sufficient information is furnished to the Secretary (at least 30 days before any such notice is mailed to the tax matters partner) to enable the Secretary to determine that the partner is entitled to the notice. An exception to the notice requirement is made for anyone with a less than one-percent interest in the profits of a partnership with more than 100 partners. However, a group having an interest in the aggregate of 5 percent or more in partnership profits may designate a member of the group to receive notice on behalf of the group. Otherwise, the notice furnished the tax matters partner (TMP) is treated as notice to these small partners.

In providing notices, the Secretary may use the names, addresses, and profits interests shown on the partnership return or may use other information furnished by the TMP or other person pursuant to regulations.

The TMP is the general partner so designated pursuant to regulations or, in the absence of such designation, the partner with the largest profits interest in the partnership at the end of the year involved (in the event there are several partners so qualifying, the one whose name would appear first in an alphabetical listing is selected). Otherwise, the TMP will be selected by the Secretary. Since the identity of the TMP may not be known to the Secretary, mailing of any notice in care of the tax matters partner at the address where the partnership business is carried on will constitute mailing of the notice for purposes of determining whether other requirements imposed on the Secretary are complied with or whether any action, such as mailing notices to other partners, is timely taken.

If the information furnished the Secretary is sufficient, the names, addresses, and profits interests of persons with profits interests in the partnership through one or more pass-through partners will be used with respect to such profits interests in lieu of the names, addresses, and profits interests of the pass-through partners.

Notice partners are entitled to have notice of the partnership proceeding mailed to them at least 120 days before the notice of the FPAA is mailed to the TMP and to have the notice of the FPAA mailed to them not later than 60 days after such notice is mailed to the TMP. Notice partners for this purpose include partners with a less than one-percent interest in profits (in partnerships with over 100 partners), and the notice requirement as to such partners is satisfied by notice to the TMP, or if such partner is a member of a 5-percent or greater group, by notice to the designated member of such group.

Late notification

If, when notice of the proceeding is mailed to any partner, the period within which to commence a judicial proceeding to redetermine the FPAA has expired without commencement of such a proceeding, or if any court decision has became final, the partner may elect to have such determination, such court decision, or a settlement agreement entered into with another partner with respect to the same partnership year apply. If the partner does not so elect, all partnership items will be treated as nonpartnership items in determining his liability. If administrative or judicial proceedings have not terminated but the notice of the proceeding is untimely, the partner will be a party to the proceedings unless he elects to have the terms of a settlement with any other partner applied to him or to have all partnership items treated as nonpartnership items.

Other notice requirements

Only one notice of FPAA may be mailed to a partner for any one year of a partnership in the absence of fraud, malfeasance, or a misrepresentation of a material fact.

To the extent provided in regulations, the TMP will be required to keep partners informed of all administrative and judicial proceedings. Notices received by pass-through partners must be forwarded within 30 days to persons holding an interest in partnership profits or losses through the pass-through partner. The responsibility for forwarding such notices is on the TMP of any pass-through partner which is itself a partnership. It was intended that no obligation will be imposed on the TMP with respect to partners wishing to be informed about routine or minor events.

All partners have a right to participate in the partnership proceeding but may waive such rights and any restrictions, such as a restriction on assessment, on the Secretary. The place and time of meetings and other events involving the Internal Revenue Service will be determined by Service representatives and the TMP.

Settlements

Settlement agreements, in the absence of fraud, are binding on the Secretary and partners participating in the settlement, except as the settlement may otherwise provide. Indirect partners, unless properly identified as required by the statute, will be bound by settlements entered into by the pass-through partner. The Secretary must offer to any partner who so requests settlement terms that are consistent with the settlement with any other partner. Except where notice to a partner of the proceeding was not timely, a request for such settlement terms must be made, with respect to any settlement entered into before the mailing of a notice of FPAA to the TMP, before the expiration of 150 days after such mailing.

The TMP may enter into a settlement on behalf of, and binding upon, less than one-percent profits partners, in partnerships with over 100 partners, who are not members of a notice group. However, any such partner may file a statement within the time prescribed by the Secretary providing that the TMP does not have authority to settle on behalf of such partner. No partner other than the TMP (and other than a pass-through partner with respect to indirect partners) may bind any other partner with respect to a settlement agreement.

Assessment of tax

Any deficiency resulting from an administrative determination generally may not be assessed until 150 days after mailing the notice of FPAA to the TMP, or if within the 150-day period a Tax Court proceeding is commenced, until the decision in such proceeding has become final. Any action to assess or collect the tax in violation of this restriction may be enjoined in the proper court.

If a timely court proceeding is not commenced, the deficiency assessed against any partner with respect to partnership items affected by a FPAA may not exceed the amount determined in accordance with such adjustment.

Judicial review of FPAA

Commencement of action

The TMP, within 90 days after the mailing of the notice of FPAA, may file a petition for readjustment of partnership items in the Tax Court, the district court of the United States for the district in which the partnership's principal place of business is located, or the Claims Court. During such 90-day period, no other partner may file a petition for judicial review.

If the TMP does not file a petition, any notice partner or 5-percent group with an interest in the outcome may, within 60 days following such 90-day period, file a petition with any of the courts in which the TMP may file a petition. Only one proceeding may go forward. The first action filed in the Tax Court will establish jurisdiction or, if no petition is filed with the Tax Court, the first action filed in either of the other courts will go forward. Other actions will be dismissed. The TMP may intervene in an action brought by another partner.

Right to participate

Each partner with an interest in the outcome shall be treated as a party to the action and will be allowed by the court to participate in the action. A partner does not have an interest in the outcome after partnership items as to such partner become nonpartnership items (under sec. 6231(b)), or the period for assessment with respect to partnership items of such partner has expired.

Deposit requirement where action in district court or Claims Court

As a condition to filing a petition in either the appropriate district court or the Claims Court, the partner filing the petition (including each member of a 5-percent group which files a petition) must deposit with the Secretary the amount by which such partner's tax liability would be increased if treatment of partnership items on the partner's return were made consistent with the partnership return as adjusted by the FPAA. The court may by order determine that this jurisdictional requirement is satisfied if a good faith effort to comply was made and any shortfall in the amount required to be deposited is timely corrected.

The amount required to be deposited will be refunded upon request of the depositing partner if jurisdiction to proceed is established in the Tax Court. However, if, upon expiration of the 150 day filing period, no Tax Court petition is filed, the Secretary may assess any deficiency of the depositing partner resulting from the FPAA and apply such deficiency against the deposited amount. Likewise, the Secretary may assess and collect any deficiencies of other partners resulting from the FPAA if jurisdiction is established in the district court or Claims Court pending a decision on the merits.

Any amount required to be deposited shall, while deposited, be treated as a payment of tax only for purposes of Chapter 67, relating to interest.

Scope of judicial review

The court acquiring jurisdiction of a partnership proceeding shall have jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the FPAA relates and the proper allocation of such items among the partners. The court's decision has the effect of a final decision of the Tax Court or a final judgment or decree of the district court or Claims Court and will be reviewable if review is sought by the TMP, a notice partner, or a 5-percent group.

Dismissal of an action, other than a dismissal for lack of jurisdiction, shall be considered a decision that the FPAA is correct.

Request for administrative adjustment

General rule

A partner may file a request for administrative adjustment (RAA) of partnership items for a partnership taxable year within 3 years after the partnership return was filed (or, if later, the last day for filing such return, determined without extension) and before the mailing of a notice of FPAA to the TMP for such taxable year.

Request by TMP on behalf of the partnership

An RAA, filed by the TMP on behalf of the partnership, may serve as an amended return correcting the treatment of items on the original partnership return, in which case the Secretary may treat the changes made as corrections of clerical or mathematical errors on the original return.

In other cases, an RAA generally serves as a claim for refund. In such cases, when the RAA is filed by the TMP on behalf of the partnership, the Secretary may (i) make all refunds and credits to all partners resulting from the requested adjustments provided the adjusted items continue to be partnership items with respect to any partner, or (ii) commence a partnership proceeding.

The RAA filed by the TMP on behalf of the partnership must show the effect of the requested adjustments on the distributive shares of the partners and other information as required by regulations.

Other requests

Each partner may file an RAA on his own behalf. In such case, the Secretary may (i) process the request in the same manner as a claim for refund relating to nonpartnership items, (ii) assess any tax resulting from the requested adjustments, (iii) notify the partner that all items to which the request relates will be treated as nonpartnership items, or (iv) commence a partnership proceeding.

Judicial review of request by TMP on behalf of the partnership

The TMP may file a petition for review in the Tax Court, the appropriate district court, or the Claims Court after the expiration of 6 months from the date of filing the RAA and within 2 years of such filing, with respect to any part of the requested adjustment not allowed. Such a petition may not be filed after a notice of the commencement of a partnership proceeding is mailed to the partnership. If, when such notice is mailed, the 2-year period within which a petition could have been filed has not expired and the Secretary fails to mail timely notice of a FPAA, the TMP shall have 6 months after the expiration of the period in section 6229(a) within which to file a petition. The TMP and the Secretary may agree to extend the 2-year period for filing a petition.

In any event, no petition for review with respect to an RAA may be filed after a timely notice of FPAA has been mailed by the Secretary. If the petition has been filed when a timely notice of FPAA is mailed, the proceeding will be treated as a proceeding with respect to the FPAA, except that no deposit will be required to establish jurisdiction in the appropriate district court or the Claims Court.

Other partners are to be treated as parties to any action brought by the TMP with respect to unallowed adjustments requested in an RAA under rules similar to those applicable when a petition is filed to review a FPAA.

Judicial review of an RAA filed by the TMP is limited to unallowed items to which the request relates and items with respect to which the Secretary asserts an offset to requested adjustments. The court's decision has the same effect as, and is reviewable in the same manner as, a court decision reviewing a FPAA.

Suits by individual partners

With respect to other RAAs if the Secretary notifies a partner that the partner's partnership items for the partnership taxable year to which a timely request relates are to be treated as nonpartnership items, the request will be considered as a claim for refund and the partner may bring an action under section 7422 within 2 years after mailing of such notice.

Otherwise, if any part of the RAA is not allowed, the partner may, after 6 months and before 2 years from the date the request was filed, commence a suit for refund under section 7422 and the partner's partnership items for the partnership taxable year to which the request related will be treated as nonpartnership items.

The 2-year period for filing suit may be extended by agreement between the partner and the Secretary.

An action based on unallowed items in an RAA may not be commenced after the Secretary mails notice of the commencement of a partnership proceeding to the partnership. If the 2-year period for filing suit has not expired when such notice is mailed, the rules applicable to a suit by the TMP are also applicable to other partners in the event there is no timely FPAA.

Statute of limitations on assessments

General rules

The period for assessment with respect to partnership items (or affected items) for any partnership taxable year shall not expire before 3 years from the date of filing the partnership return or, if later, the last date prescribed for filing such return determined without extensions. The period may be extended by agreement with any partner or, for all partners, by agreement with the TMP (or other person authorized in writing by the partnership). The agreement must be entered into before the expiration of the period to be extended. An agreement under section 6501(c)(4) (relating to agreements to extend the period for assessment) will apply to partnership items only if it expressly so provides.

Assessments may be made at any time against partners signing or participating directly or indirectly in the preparation of a fraudulent return. Against other partners affected by such return, the period for assessment is extended from 3 to 6 years.

The period of assessment is 6 rather than 3 years in any case where there is an omission from gross income of an amount properly includible which exceeds 25 percent of the amount of the gross income stated in the return.

Assessments may be made at any time where no partnership return is filed. For this purpose, a return filed by the Secretary on behalf of the partnership under section 6020(b) shall not be treated as a return filed by the partnership.

Suspension of limitations

The period for assessment is suspended upon mailing of a notice of FPAA until the expiration of the period during which a petition for judicial review may be filed by any partner (or, if an action is brought during such period, until the decision of the court has become final) and for one year thereafter.

Unidentified partners, inconsistency

Where a partner was not properly identified on the partnership return and a timely notice of FPAA was mailed to the TMP, or a partner's treatment of partnership items on his return did not comply with the consistency requirement in section 6222 and the inconsistency was not identified as required by that section, the assessment period will not expire until one year after the name, address, and taxpayer identification number of such partner are furnished to the Secretary.

Items becoming nonpartnership items

Where, before the expiration of the period for assessment, an item becomes a nonpartnership item by reason of an event described in section 6231(b), the period of assessment of any tax attributable to such item (or an affected item) shall not expire until one year after the date on which the item becomes a nonpartnership item.

Computational adjustments

Computational adjustments, generally

The procedure applicable to assessment of a deficiency will not apply to computational adjustments. Computational adjustments are changes in tax liability of a partner properly reflecting the treatment, under the rules adopted in the Act, of partnership items. The term includes all adjustments necessary to apply the results of a partnership proceeding to an indirect partner.

Adjustments necessary to correct mathematical or clerical errors (as defined in sec. 6213(g)(2)) appearing on the partnership return may be made without a partnership proceeding and opportunity for judicial review, except as to any partner who requests that such correction not be made within 60 days after notice of the correction is mailed to such partner.

Claim by partner

A claim may be filed on the ground that there was an erroneous computation of the adjustment necessary (i) to make the partnership items on the partner's return consistent with the treatment of such items on the partnership return, or (ii) to apply to the partner a settlement, a FPAA, or a final court decision relating to the treatment of partnership items. A claim may also be based on a failure to allow a refund or credit in the proper amount. A claim based on an alleged erroneous computation must be filed within 6 months after the date of mailing the notice of computational adjustment to the partner. A claim based on a failure to allow a credit or make a refund in the proper amount must be filed within 2 years after, as appropriate, (i) the date the settlement was entered into, (ii) the date on which the period for bringing an action to review a FPAA expires, or (iii) the date a court decision becomes final.

Right to file suit

To the extent a claim based on failure to properly apply computational adjustments to the partner is not allowed, suit may be filed within the period prescribed in section 6532(a). In any claim or suit involving the application of computational adjustments to the partner, the treatment of partnership items on the partnership return, under the settlement, under the FPAA, or under the court decision (as appropriate) shall be conclusive.

Limitations applicable to credits and refunds

Generally, the period of limitations prescribed for assessment with respect to partnership items will also apply to allowance of any credit or refund with respect to partnership items.

Credit or refund based on a timely filed RAA may be made at any time before the expiration of the period for filing suit with respect to such request.

Credit or refund based on a claim with respect to the application to the partner of a computational adjustment may be made before the expiration of the period specified in section 6532 for bringing suit on such claim.

The limitation on the period for making a credit or refund to a partner will not apply if a timely suit is brought by the partner based on an RAA or an unallowed claim with respect to a computational adjustment.

Credits or refunds attributable to partnership items to the extent practicable, will be made without requiring that the partner file a claim.

The limitations generally applicable to the allowance of credits or refunds (subchapter B of Chapter 66) will not apply to credits or refunds of overpayments attributable to partnership items.

Certain other rules

When a notice of the commencement of a partnership proceeding is mailed to the TMP with respect to a partnership taxable year, the TMP is to furnish to the Secretary the names, addresses, and taxpayer identification numbers of each person who was a partner at any time during such taxable year. Revised or additional information is to be furnished at a later date by the TMP when the TMP discovers the information furnished was inaccurate or incomplete. Failure by the TMP, a pass-through partner, the representative of a 5-percent notice group, or other representative of a partner to provide any notice or take any action required under the rules or under regulations on behalf of any partner will not affect the applicability of any partnership proceeding or adjustment under the rules to such partner.

The principles of section 7481(a) shall govern in determining the date on which a court decision becomes final.

The authority granted to the Secretary by section 7602 (relating to the examination of books and witnesses) is not limited by the rules adopted by the Act.

All statements, elections, requests, and furnishing of information are to be made or filed in such manner, and at such time and place, as prescribed by regulations.

The principal place of business of a partnership, if outside the United States, shall be treated as located in the District of Columbia for purposes of filing a petition in the appropriate district court under section 6226 or section 6228.

The statute grants explicit authority to adopt regulations as necessary to carry out the purpose of the statutory rules.

Judicial actions brought under the rules are to be conducted in accordance with such rules of practice and procedure as the court may prescribe.

Small partnerships

Generally, partnerships covered by the rules include any partnership required to file a return under section 6031(a).

However, the rules do not apply to partnerships consisting of 10 or fewer partners each of whom is a natural person (other than a nonresident alien) or an estate, provided that each partner's share of any partnership item is the same as his distributive share of every other partnership item. A husband and wife (and their estates) shall be treated as one partner for purposes of this exception. A partnership eligible to be excluded under this provision may elect to be covered by the rules. The election is binding for the year for which it is made and subsequent years unless revoked with the Secretary's consent.

Certain definitional and other rules

Certain definitions

The term 'partner', for purposes of the rules, means a direct partner in the partnership or any other person whose income tax liability is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership.

The term 'partnership item' means any item required to be taken into account for the partnership's taxable year to the extent regulations provide that such item is more appropriately determined at the partnership level than the partner level. The term 'affected item' means any item to the extent it is affected by a partnership item.

The term 'pass-through partner' means a partnership, estate, trust, subchapter S corporation, nominee, or other similar person through whom other persons hold an interest in a partnership with respect to which there is a partnership proceeding. The term 'indirect partner' means any person holding an interest through one or more pass-through partners.

Except as regulations may provide otherwise, a husband and wife with a joint interest in a partnership shall be treated as one person, e.g., for determining whether a partnership has more than 100 partners.

Nonpartnership items

Partnership items will become nonpartnership items as of the date that (i) the Secretary mails a notice to the partner that such items will be treated as nonpartnership items, (ii) the partner files suit under section 6228(b) after failure by the Secretary to allow an RAA with respect to such items, (iii) the Secretary enters into a settlement agreement with the partner with respect to such items, (iv) the items become nonpartnership items under section 6223(e) (relating to failure by the Secretary to provide timely notice to the partner of a partnership proceeding) or (v) under the Secretary's regulatory authority to treat items as nonpartnership items, such items become nonpartnership items.

The Secretary may notify a partner that a partnership item will be treated as a nonpartnership item where either (i) the partner has treated the item inconsistently with its treatment on the partnership return and properly identified the inconsistency under section 6222(b)(1)(B) (and has not subsequently filed an RAA which would eliminate the inconsistency) or (ii) the partner has filed an RAA and the requested adjustments would make the partner's treatment of adjusted items inconsistent with their treatment on the partnership return. Any such notification based on inconsistency on the partner's return must be mailed before the Secretary mails a notice to the TMP of the commencement of a partnership proceeding with respect to the inconsistently treated items.

Special enforcement provisions

The Act provides regulatory authority to treat items as nonpartnership items to the extent the Secretary determines their treatment as partnership items will interfere with the effective and efficient enforcement of the Internal Revenue laws. This authority extends to (i) termination assessments under section 6851 and jeopardy assessments under section 6861, (ii) criminal investigations, (iii) indirect methods of proof of income (iv) foreign partnerships, and (v) other areas to the extent determined by regulations to present special enforcement considerations.

Authority is granted to prescribe special rules by regulation determined by the Secretary to be necessary to achieve the purpose of the Act for the tax treatment of partnership items in these cases presenting special enforcement considerations.

Determination of profits interest

The profits interest of any partner shall be determined as of the close of the partnership taxable year, except that it shall be determined immediately before the liquidation, sale, or exchange of the entire interest of a person who is not a partner at the end of such year. This determination is significant in determining whether a partner's interest is one percent or more (in partnerships with over 100 partners) and in determining whether a notice group qualifies under the 5-percent requirement applicable to such groups. This determination shall be made pursuant to regulations in the case of indirect partners.

Appeal bond to stay assessment

Section 7485, relating to bond to stay assessment and collection on the appeal of a Tax Court decision, is amended to provide for such a bond on filing a notice of appeal of a decision under section 6226 or section 6228(a). The amount of such bond fixed by the Tax

Court, in the absence of a stipulation by the parties, will be based on the Tax Court's estimate of the aggregate amount of deficiencies involved.

Nonpartnership litigation

Other tax litigation not a bar to adjustment

A judicial determination of a partner's income tax liability not resulting from a partnership proceeding will not bar any adjustment to such liability attributable to the treatment of partnership items pursuant to a proceeding under these rules. Further, such a determination will not bar an adjustment resulting from a proceeding with respect to items that become nonpartnership items under the rules if, when they become nonpartnership items, it is no longer appropriate to include them in a separate proceeding involving other nonpartnership items. A judicial determination in a suit filed under section 6228(a) with respect to items not allowed in an RAA filed by the TMP will not bar adjustments with respect to other partnership items.

Continuation of existing rules for nonpartnership items

Existing rules relating to administrative and judicial proceedings, statutes of limitations, settlements, etc., will continue to govern the determination of a partner's tax liability attributable to nonpartnership items. Neither the Secretary nor the taxpayer will be permitted to raise nonpartnership items in the course of a partnership proceeding nor may partnership items, except to the extent they become nonpartnership items under the rules, be raised in proceedings relating to nonpartnership items of a partner.

The separate statute of limitations applicable to nonpartnership items of a partner may have expired when the computational adjustment of a partner's tax liability attributable to a FPAA or final court decision is made. In such case neither the Secretary (to reduce a refund) nor a partner (to reduce an assessment) may raise nonpartnership items in determining the partner's tax liability resulting from such computational adjustment. However, if the partner has in fact overpaid his income tax liability for the taxable year with respect to which the computational adjustment was made, he may obtain credit or refund of such overpayment by filing a claim within 2 years following such overpayment, as prescribed by sections 6511 (a) and (b)(2)(B). If such claim is not allowed, suit may be filed pursuant to section 7422(a). Any overpayment which may be refunded pursuant to such a claim or suit for refund would be attributable only to nonpartnership items.

Foreign-based partnerships

The Act explicitly applies the partnership return filing requirement under section 6031 to any partnership which has U.S. partners (direct or indirect). Where the TMP resides outside the United States or the partnership books and records are kept outside the United States, failure to comply with the partnership return requirement or provide the return information upon request will result in disallowance of partnership losses and credits to the partners. The Secretary may by regulation waive the reporting requirement in appropriate cases. The bill also requires a return by a U.S. person who acquires or disposes of an interest in a foreign partnership except to the extent regulations provide otherwise. This requirement extends to substantial changes in the proportionate interest of a U.S. person in a foreign partnership. The return is to be in such form and provide such information as regulations require and must be filed within 90 days after the date the U.S. person becomes liable to file such return unless the Secretary, by regulation, prescribes a later date.

The tax treatment for partnership items under subchapter C of chapter 63, as added by the Act, the partnership return filing requirement under section 6031, and the return requirement relating to changes in interest in a foreign partnership are all expressly inapplicable, under the Act, to the International Telecommunications Satellite Organization and the International Maritime Satellite Organization, and any organization which is successor to either of such organizations. Both such organizations are public international organizations established by international agreements to which the United States is a party.

Partnership must provide information to partners

Section 6031 is amended by the Act to require expressly that every partnership required to file a return shall furnish to every person who was a partner at any time during the partnership's taxable year a copy of such information shown on the return as may be required by regulation. The fact that the Act expressly imposes this requirement was not intended to imply that the Internal Revenue Service was without authority to impose a similar requirement under prior law.

Windfall profit tax audits

Windfall profit tax items are included as partnership audit items under regulations to be issued by the Treasury. Thus, the tax treatment of any partnership windfall profit tax item will be determined at the partnership level rather than the partner level. A partnership windfall profit tax item is any item relating to the computation of the windfall profit tax on crude oil produced by the partnership which the Treasury determines by regulation to be more appropriately determined at the partnership rather than the partner level. Examples of such items are (1) the removal price of crude oil, (2) the adjusted base price of the crude oil, (3) the category of the crude oil, (4) the appropriate severance tax adjustments, and (5) the net income limitation. Under regulations, the partnership will be authorized to act on behalf of its partners for purposes of the determination, examination, and collection of windfall profit tax. Thus, the partnership can be made responsible for certifying necessary withholding tax information to first purchasers and for filing quarterly and annual returns with respect to the partnership's production of domestic crude oil. When necessary, the partnership will be able to rely on certifications by its partners of their status under the windfall profit tax. On the election of one or more partners owning an interest in at least 5 percent of partnership income, this authorization will cease to apply for the entire partnership.

Each partner will remain primarily liable for the windfall profit tax on his allocable share of taxable crude oil produced by the partnership. The partner's liability will be abated to the extent of any payment of windfall profit tax by the partnership. In determining the liability of any partner for windfall profit tax purposes, each partner would be required to treat any partnership windfall profit tax item in a manner consistent with the treatment of that item on the partnership return unless the partner notifies the Secretary of an inconsistent position. Each partner will be required to certify to the partnership that partner's correct treatment under the exemption of independent stripper wells, the special rates on independent producers, the royalty owners exemption and other producer-related provisions. The partnership will compute and pay the windfall profit tax on the assumption that the certifications given by the partners are correct.

The examination and collection of tax relating to independent producer or exempt status, etc., will be conducted at the partner level. All other items are determined at the partnership level. Thus, a partner's treatment of partnership windfall profit tax items will, under regulations, be determined by reference to the treatment of such items in the hands of the partnership. Thus, for example, a partner can sue for a refund on the basis of that partner's claim of the independent producer lower rates, but can not seek a refund on the theory that oil classified as tier 2 oil by the partnership should have instead been classified as tier 3 oil.

Prior law provided the Secretary with broad authority to require the keeping of records, the making of returns, and the furnishing of information relating to the windfall profit tax. It was anticipated that the Secretary will use this authority to reduce the amount of information which must be delivered partners to by the partnership in the normal course of business and to provide for a consolidated partnership return reflecting the taxes of the individual partners. In addition, the Secretary should require under this authority that partners be given access to any and all windfall profit tax information necessary for the verification of the tax computed by the partnership or to the determination of their entitlement to independent producer lower rates or royalty owner exemptions.

The Act applies to determination, examination, and collection of windfall profit tax with respect to oil removed in taxable periods beginning after December 31, 1982, unless the partnership, each partner, each indirect partner and the Secretary consent to earlier application of the provisions.

Effective date

The amendments relating to acquisitions, dispositions, and substantial changes in the interest of a U.S. person in foreign partnerships apply in the case of such changes after the date of enactment. All other amendments apply to partnership taxable years beginning after the date of enactment. However, a partnership with the consent of all partners may choose to have such amendments apply to the first partnership taxable year ending after the date of enactment if the Secretary also consents.

11. Revenue Effect of Compliance Provisions

The provisions relating to withholding on interest and dividends are estimated to increase fiscal year budget receipts by $1,344 million in 1983, $5,246 million in 1984, $3,975 million in 1985, $4,605 million in 1986, and $5,181 million in 1987.

The other compliance provisions (items 2 through 10, above) are estimated to increase fiscal year budget receipts by $2,021 million in 1983, $3,623 million in 1984, $4,685 million in 1985, $5,569 million in 1986, and $6,036 million in 1987.

D. Pension Provisions*

Overview

If a pension, profit-sharing or stock bonus plan qualifies under the tax law (sec. 401(a), 403(a), or 405(a)), then (1) a trust under the plan is generally exempt from income tax, (2) employers are generally allowed deductions (within limits) for plan contributions for the year for which the contributions are made, even though participants are not taxed on plan benefits until the benefits are distributed, (3) benefits distributed as a lump sum distribution may be accorded special long-term capital gain treatment or 10-year income averaging treatment, or may be rolled over, tax-free, to an individual retirement account, annuity, or bond (IRA) or another qualified plan, and (4) certain estate and gift tax exclusions are provided.

Under a tax-sheltered annuity program, amounts paid by an educational institution or by an eligible tax-exempt organization to purchase an annuity contract for an employee are excluded from the employee's income, subject to certain limits (sec. 403(b)). Excludable contributions to custodial accounts investing in stock of a regulated investment company (*e.g.*, a mutual fund) are also permitted. Amounts distributed or made available under tax-sheltered annuities or custodial accounts generally are includible in gross income. However, certain total distributions may be rolled over, tax-free, to another such annuity contract or account or to an IRA. In addition, certain estate tax and gift tax exclusions apply.

If an IRA qualifies as a simplified employee pension (SEP), the annual IRA deduction (generally, the lesser of $2,000 or 100 percent of compensation) is increased by the lesser of $15,000 or 15 percent of compensation. The increase in the deduction limit applies only to employer contributions (sec. 219). Except in the case of certain correcting distributions, all distributions from SEPs are includible in gross income unless rolled over to another IRA. Amounts held in a SEP can qualify for exclusions under the estate tax and gift tax rules for IRAs.

---

*For legislative background of the pension provisions, see: H.R. 4961, as reported by the Senate Finance Committee, secs. 246-254; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 312-332; and H. Rep. No. 97-760 (August 17, 1982), pp. 617-640 (Joint Explanatory Statement of the Committee of Conference).

1. Limits on contributions and benefits (secs. 235 and 245 of the Act and secs. 401, 404, 415, 1379, and 2039 of the Code)

Prior Law

Overall limits

In order to limit the extent to which individuals can use tax-favored arrangments to provide for retirement, the Code (sec. 415) provides overall limits on contributions and benefits under qualified pension, etc., plans, tax-sheltered annuities, and simplified employee pensions (SEPs). The overall limits apply to contributions and benefits provided to an individual under all qualified plans, tax-sheltered annuities, and SEPs maintained by any private or public employer or by certain related employers.

Under a profit-sharing or other defined contribution plan,[1] the qualification rules provide an overall limit on the annual addition with respect to each plan participant (sec. 415(c)). Under prior law, the annual addition (consisting of employer contributions, certain employee contributions, and forfeitures allocated from the accounts of other participants) generally was limited to the lesser of (1) 25 percent of compensation for the year, or (2) $25,000, adjusted for cost-of-living increases as measured by the Consumer Price Index (CPI) since 1974. The limit for 1982 was $45,475. The defined contribution plan limit also applies to tax-sheltered annuities and SEPs.

Under a defined benefit pension plan[2] the annual benefit derived from employer contributions was subject to an overall limit of the lesser of (1) 100 percent of average compensation, or (2) $75,000, adjusted for cost-of-living increases since 1974 (sec. 415(b)). The limit for 1982 is $136,425.

Maximum benefits payable upon early retirement

Under the prior-law limits for a defined benefit plan, the annual benefit was generally the equivalent of an annuity for the life of the employee, beginning at age 55 or later, and determined without regard to certain survivor and non-retirement benefits. If retirement benefit payments began before age 55, the dollar limit ($136,425 for 1982) was actuarially reduced to the equivalent of the dollar limit at age 55.

---

[1] A defined contribution plan is one under which each participant's benefit is based solely on the balance of the participant's account consisting of contributions, income, gain, expenses, losses, and forfeitures allocated from the accounts of other participants.

[2] A defined benefit pension plan specifies a participant's benefit independently of an account for contributions, etc. (*e.g.*, an annual benefit of two percent of average pay for each year of employee service).

Aggregate limit

If an employee participates in a defined contribution plan and a defined benefit plan maintained by the same employer, the fraction of the separate limit used by each plan is computed and the sum of the fractions is subject to an overall limit (415 (e)). The prior-law limit on the sum of the fractions was 1.4. Under prior law the numerator of the defined benefit plan fraction was the projected annual benefit of the participant under the plan determined as of the close of the year and the denominator was the maximum benefit allowed.

The numerator of the defined contribution plan fraction was the total amount of annual additions to the participant's account through the close of the year and the denominator was the maximum amount of annual additions which could have been made for the participant if the plan provided the maximum allowable annual addition for the year and all prior years of service with the employer.

Reasons for Change

Congress recognized the importance of tax incentives in creating a strong pension system. At the same time, however, Congress believed it was necessary to provide more appropriate limitations on contributions and benefits to prevent excessive accumulations of tax-deferred funds by high-income people.

Explanation of Provisions

Overview

The Act made several changes to the overall limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, and SEPs of private and public employers. The dollar limit on the annual addition under defined contribution plans is decreased from $45,475 to $30,000, and the dollar limit on the annual benefit payable under defined benefit plans is decreased from $136,425 to $90,000. All cost-of-living adjustments to these amounts are suspended until 1986. In addition, for participants covered by both a defined contribution plan and a defined benefit plan of the same employer, the limit on the sum of the fractions of the separate limit used by each plan is reduced to the lesser of 1.25 (as applied only to the dollar limits) or 1.4 (as applied to the percentage of compensation limits).

Under the Act, if the retirement benefit under a defined benefit plan begins before age 62, the $90,000 limitation generally is reduced so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at age 62.

Under transition rules provided by the Act, benefits already accrued by a plan participant under an existing plan are not affected by the reductions.

Overall limits

Under the Act, the dollar limit on the annual addition for an employee under defined contribution plans of an employer is decreased from $45,475 to $30,000. The 25 percent of compensation limit is not changed.

The dollar limit on employer-derived annual benefits for an employee under defined benefit plans is decreased from $136,425 to $90,000. The 100 percent of compensation limit is not changed. Further, under the rules relating to the overall limit on annual benefits, the value of benefits paid in a form other than a single life annuity may not exceed the actuarial equivalent of a single life annuity equal to the applicable limit (the lesser of the dollar or percentage limit). Under the Act, actuarial equivalence is to be determined by using an interest rate assumption of not less than the greater of five percent or the rate (if any) specified in the plan for purposes of converting plan benefits. For example, if a defined benefit pension plan permits a participant to elect a lump sum distribution, then the lump sum is within the applicable limit only if it does not exceed the value of a single life annuity using an interest rate at least equal to the prescribed minimum. In no event, however, can future cost-of-living increases to the dollar limit be assumed in determining actuarial equivalence.

The Act continues prior law, under which, if a benefit is paid in the form of a joint and survivor annuity for the benefit of the participant and his spouse, the survivor benefit is taken into account only to the extent that the benefit is greater than the joint benefit. Also, as under prior law, the maximum allowable benefit is reduced for an employee with less than 10 years of service with the employer.

The Act suspends cost-of-living adjustments to the overall dollar limits. The $30,000 and $90,000 limits, first effective in 1983 for plans in existence on July 1, 1982, will not be increased in 1983, 1984, or 1985. Beginning in 1986, the limits will be adjusted for post-1984 cost-of-living increases under the formula then in effect to provide cost-of-living increases in social security benefits. The Congress intended that, in 1983, the Secretary of the Treasury is not to make adjustments to the dollar limits in effect for 1982 ($136,425 and $45,475).

For 1983, 1984, and 1985 no change is made to the prior-law provision for defined benefit plans which permits adjustment of the 100 percent of compensation limit to reflect post-separation cost-of-living increases for participants who have separated from service. Beginning in 1986, permitted post-separation adjustments will be made under the rules providing adjustments to the overall dollar limits.

The Act clarifies prior law by providing that anticipated cost-of-living adjustments to the overall benefit limits may not be taken into account under the rules relating to the deduction allowed for employer contributions to a qualified plan.

Dollar limits for benefits payable upon early or delayed retirement

Under the Act, if retirement benefits under a defined benefit plan begin before age 62, the $90,000 limit (but not the 100 percent of compensation limit) generally is reduced so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at age 62. However, the Act provides that in no event will the dollar limit for benefits commencing at or after age 55 be reduced below $75,000.

Thus, the dollar limit for benefits which commence at or after age 55 and before age 62 will be the greater of (1) the actuarial equivalent of the usual, inflation-adjusted, dollar limit ($90,000 for 1983) for benefits commencing at age 62, or (2) $75,000. In addition, for benefits commencing before age 55, the applicable dollar limit will be the greater of (1) the actuarial equivalent of the usual, inflation-adjusted, dollar limit for benefits commencing at age 62, or (2) the actuarial equivalent of a $75,000 annual benefit commencing at age 55.

Under the Act, the reduction in the dollar limit for benefits commencing before age 62, and the reduction in the $75,000 amount for benefits commencing before age 55, must be computed using an interest assumption not less than the greater of five percent or the rate specified in the plan for purposes of determining benefits payable before the normal retirement age. As under prior law, there is no required reduction for pre-retirement ancillary benefits (such as medical, death, or disability benefits), but adjustments are required to reflect post-retirement ancillary benefits such as term-certain annuities, postretirement death benefits, etc.

The Act also provides that if retirement benefits under a defined benefit plan begin after age 65, the $90,000 limit is increased so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at age 65. The increase is to be computed using an interest rate assumption not greater than the lesser of five percent or the rate specified in the plan. Although both interest and the decreased term over which the annual benefit is payable may be taken into account to increase the $90,000 limit, the probability of an individual's dying after age 65 and before the age at which the payment of the benefit would commence may not be taken into account to increase the dollar limit if the plan does not provide for forfeiture on death in that period.

Of course, this provision does not prohibit an employee from retiring prior to age 62, and it does not mandate actuarial reductions in plan benefits commencing prior to age 62 where the limits are not exceeded. Similarly, the Act does not require that a plan provide increased benefits for participants retiring after age 65.

Aggregate limit

The Act redefines the defined benefit plan and defined contribution plan fractions used to compute the aggregate limit for an individual who participates in both types of plans maintained by the same employer. Under the Act, the sum of the two fractions may not exceed 1.0, but the revised plan fractions effectively provide an aggregate limit of the lesser of 1.25 (as applied with respect to the dollar limits) or 1.4 (as applied to the percentage limits) because of adjustments to the denominators.

The numerator of the new defined benefit plan fraction, as under prior law, is the projected annual benefit under the plan, determined at the close of the year. The denominator is redefined as the lesser of (i) 1.25 multiplied by the dollar limit in effect for the year ($90,000 for 1983) or (ii) 1.4 multiplied by the amount of compensation which may be taken into account for that year under the applicable percentage limit.[3]

The numerator of the new defined contribution plan fraction, as under prior law, is the total amount of annual additions to the participant's account through the close of the year. The denominator is redefined as the sum of the lesser of the following amounts, computed separately for such year and each prior year of service with the employer: (i) 1.25, multiplied by the dollar amount for such year (*e.g.*, $30,000 for 1983)[4] or (ii) 1.4, multiplied by the applicable percentage limit.

Deduction limits

The Act also provides that no deduction is permitted for any year for employer contributions used to provide any benefits or annual additions in excess of the limits applicable to that year. Thus, in the case of a defined benefit plan, no benefits in excess of the limits may be taken into account for purposes of computing the applicable deduction limit. Similarly, contributions taken into account in computing an employer's deduction for contributions to a defined contribution plan must be reduced by the amount by which the annual addition for an employee exceeds the limit for the employee.

In addition, the Act clarifies prior law by providing that an employer's deduction limit for the year under a defined benefit plan may not be based on benefits in excess of the dollar limit applicable for the year (without regard to anticipated cost-of-living increases in the limits). Deductions may, however, be based on benefits (not in excess of the dollar limits for the current year) which take into account anticipated salary increases.

Estate tax exclusion

The Act also places a $100,000 aggregate limit on the estate tax exclusion for certain retirement benefits payable under qualified pension, etc., plans, tax-sheltered annuities, individual retirement accounts, annuities, or bonds (IRAs), and certain military retirement plans (sec. 2039). This estate tax exclusion for retirement benefits is allowed in addition to any other exclusion or deduction (*e.g.*, the marital deduction (sec. 2056)) allowed with respect to such benefits. For example, if a lump sum distribution is paid to the surviving spouse of a deceased participant under a qualified plan, the distribution (including such a distribution which is rolled over by the surviving spouse to an IRA (sec. 402(a)(7)) is eligible for the marital deduction. The full amount of the $100,000 exclusion may then be applied to amounts payable with respect to the decedent under another qualified plan or an IRA to a beneficiary other than the surviving spouse.

As under prior law (sec. 2039(f)), no amount included in a lump sum distribution payable under a qualified plan is eligible for the

---

[3] However, if the participant's current accrued benefit determined pursuant to the transitional rules exceeds $90,000, the denominator of the defined benefit fraction would be the lesser of (1) 1.25, multiplied by the dollar amount of the current accrued benefit, or (2) 1.4, multiplied by the compensation which may be taken into account under the percentage limit.

[4] The dollar amount used to compute that denominator for any year is the actual dollar limit in effect for that year (*e.g.*, $45,475 for 1982, $41,500 for 1981, etc.)

$100,000 exclusion unless the beneficiary irrevocably elects to treat the distribution as taxable without regard to the capital gain and ten-year income averaging rules generally applicable to lump sum distributions. Similarly, amounts payable from an IRA are eligible for the exclusion only to the extent such amounts are payable as a qualifying annuity (sec. 2039(e)).

Effective Dates

In general

For plans not in existence on July 1, 1982 (including plans maintained by employers who, after July 1, 1982, adopt master or prototype plans which were in existence on that date), the provisions reducing the overall limits apply to years ending after July 1, 1982. A plan is considered to have been in existence on July 1, 1982, if on or before that date the plan was reduced to writing and adopted by the employer (including, in the case of a corporate employer, formally approved by the employer's board of directors and, if required, shareholders), even though no amounts had yet been contributed under the plan.

For plans in existence on July 1, 1982, the provisions generally apply to years beginning after December 31, 1982. However, a plan which was in existence on July 1, 1982, will not fail to be qualified for any year beginning before January 1, 1984, merely because the plan may provide benefits or contributions which, though not exceeding the overall limits in effect prior to the amendments made by the Act, exceed the limits as amended. Thus, employer deductions with respect to years beginning after December 31, 1982, will be limited to those amounts required to fund the lower limits provided by the Act (whether or not contributions required by the plan or the minimum funding standard (sec. 412) exceed those limits).

For purposes of tax-qualification, in any case in which an employer maintains both a plan which was in existence on July 1, 1982 (an existing plan) and a plan which was not in existence on that date (a new plan), the Act's qualification provisions apply with respect to the existing plan for years beginning after December 31, 1983, and with respect to the new plan for years ending after July 1, 1982. For example, if both plans are defined contribution plans, qualification of the existing plan for years beginning before January 1, 1984, is determined by taking into account $45,475 as the dollar limit applicable to the sum of the annual additions for an employee under the existing and new plans. However, qualification of the new plan for years ending after July 1, 1982, is determined by taking into account $30,000 as the dollar limit applicable to the sum of the annual additions for the employee under the two plans. Of course, the employer's deduction for contributions to the existing plan (for years beginning after December 31, 1982) and the new plan (for years ending after July 1, 1982) are computed by reference to the $30,000 limit.

If both plans are defined benefit plans, qualification of the existing plan for years beginning before January 1, 1984, is determined by taking into account $136,425 as the dollar limit applicable to the sum of the annual benefits provided for an employee under the two plans, but qualification of the new plan for years ending after July 1, 1982, is determined by taking into account $90,000 as the dollar limit applicable to the sum of the annual benefits provided under the plans. For deduction purposes, the amount taken into account under the existing plan (for years beginning after December 31, 1982) and the new plan (for years ending after July 1, 1982) is limited to $90,000 (or, if greater, the participant's current accrued benefit).

Similar rules apply with respect to the Act's revision to the aggregate limit for an employee who participates in both a defined benefit plan and a defined contribution plan of the same employer. With respect to the plan in existence on July 1, 1982 (whether a defined contribution or a defined benefit plan), qualification of the plan for years beginning before January 1, 1984, is determined by taking into account 1.4 as the limit on the sum of the fraction computed for the existing plan and the fraction computed for the new plan. The fraction for each plan would be computed as under prior law (*i.e.*, without regard to the Act's revisions to either the defined contribution plan or defined benefit plan fraction). Of course, the denominator of the fraction for the new plan would reflect the Act's new dollar limits.

With respect to the plan not in existence on July 1, 1982, qualification for years ending after that date is determined by taking into account 1.0 as the limit on the sum of the fractions computed for the two plans. The fraction for each plan would be computed taking into account the Act's revisions to both the defined contribution plan and defined benefit plan fraction. The denominator of each fraction would reflect the Act's new dollar limits (or, in the case of a defined benefit plan, the participant's current accrued benefit, if greater).

The provisions which suspend the cost-of-living adjustments apply to adjustments which would have been made in years beginning after December 31, 1982, and before January 1, 1986. Thus, any adjustments to the dollar limits that would otherwise be made after December 31, 1982, and before January 1, 1986, will not be made.

Collectively bargained plans

The Act provides a special effective date for plans maintained on the date of enactment (September 3, 1982), pursuant to one or more collective bargaining agreements between employee representatives and one or more employers. Under the Act, the new limits on benefits and contributions will not apply to years beginning before the earlier of (i) the date on which the last of the collective bargaining agreements terminates or (ii) January 1, 1986. For this purpose, any extensions of the collective bargaining agreement agreed to after September 3, 1982, will be disregarded. In addition, any plan amendment which amends the plan solely to conform to the amendments made by the Act (with respect to benefit limits and distribution requirements) will not be considered a termination or extension of the collective bargaining agreement.

If a plan involves both collective bargaining unit employees and other employees, the effective dates applicable to collectively bargained plans apply if at least 25 percent of the plan participants are members of the employee unit covered by the collective bargaining agreement.

Transitional rules

Current accrued benefits

The Act provides a transitional rule to insure that a participant's previously accrued benefit under a defined benefit pension plan is not reduced merely because the Act reduces the dollar limits on benefits payable under the plan. The rule applies with respect to an individual who is a participant before January 1, 1983, in a plan which was in existence on July 1, 1982. If such an individual has a current accrued benefit that exceeds the Act's dollar limit (but which does not exceed the dollar limit in effect under prior law), then the applicable dollar limit for the individual is equal to that current accrued benefit. Similarly, in computing the participant's new defined benefit fraction under the Act, the current accrued benefit would replace the dollar limit otherwise used in the denominator of the fraction.

Under the Act, an individual's current accrued benefit is the individual's accrued benefit as of the close of the last year beginning before January 1, 1983, expressed as an annual benefit determined pursuant to the rules in effect prior to the amendments made by the Act. Thus, for example, the annual benefit could be computed without requiring any actuarial reduction for benefits commencing before age 62 and after age 55, unless the plan, as in effect on July 1, 1982, otherwise required reductions.

For purposes of determining an individual's current accrued benefit, no change in the terms and conditions of the plan after July 1, 1982, is taken into account. Accordingly, if an individual's current accrued benefit is a specified percentage of average pay, rather than a specified amount, the current accrued benefit is the specified percentage of the average pay computed as of the close of the last year beginning before 1983, based upon compensation paid up to that time. Although subsequent salary increases might increase the benefit to which a participant is entitled under the plan, those increases would not increase the partcipant's current accrued benefit. Similarly, cost-of-living adjusments occurring after 1982, are not taken into account in computing the current accrued benefit. In addition, with respect to an individual whose annual benefit is treated as not exceeding the annual benefit limit (sec. 415(b)) on account of the transitional rule provided by section 2004(d)(2) of the Employee Retirement Income Security Act of 1974, the individual's accrued benefit is the individual's annual benefit.

The Act does not affect the obligation of a plan to provide the current accrued benefit and the Act does not affect the consequences of an employer's failure to fund an individual's current accrued benefit. However, no further accruals would be permitted for an individual whose current accrued benefit exceeds the Act's usual dollar limit until that dollar limit, as adjusted for cost-of-living increases, exceeds the individual's current accrued benefit.

With respect to a plan maintained on September 3, 1982, pursuant to one or more collective bargaining agreements, the current accrued benefit of an individual is the individual's accrued benefit as of the close of the last year beginning before the earlier of (i) the date on which the last of the collective bargaining agreements terminates or (ii) January 1, 1986.

Defined contribution plan fraction

The Act also provides a special, elective transitional rule for computing the defined contribution plan fraction. The rule allows the computation for all years ending before January 1, 1983, to be based solely upon an adjusted 1982 defined contribution plan fraction.

Rather than recompute the denominator in each participant's defined contribution plan fraction for each pre-1983 year, a plan administrator may elect to adjust the denominator by taking into account only the dollar limit for the year ending in 1981 ($41,500), and the individual's compensation for that year. Under this provision, the denominator of the individual's defined contribution plan fraction for the year ending in 1982 (as determined under the rules in effect before the amendments made by the Act) is multiplied by a transition fraction. The numerator of the transition fraction is the lesser of (1) $51,875 ($41,500 multiplied by 1.25), or (2) 1.4 multiplied by 25 percent of the individual's compensation for the year ending in 1981. The denominator of the fraction is the lesser of (1) $41,500, or (2) 25 percent of such 1981 compensation.

If a plan administrator elects to use the transition fraction with respect to any plan participant, the transition fraction must be used for to all participants in the plan. Similarly, an election by a plan administrator to utilize the transition fraction with respect to a plan of an employer applies with respect to all defined contribution plans of that employer and certain related employers (sec. 414(b), (c), or (m)).

The election to utilize the transition fraction may be made with respect to a defined contribution plan which was in existence on (or which was terminated before) July 1, 1982, without regard to whether the overall aggregate limit (sec. 415(e)) applied with respect to annual additions under the plan on (or before) that date. The election does not apply to a plan not in existence on or before July 1, 1982.

Aggregate limit

The Act provides a special transitional rule to grant a "fresh start" for individuals who participate in both a defined benefit plan and a defined contribution plan maintained by the same employer. Where the sum of the revised defined benefit plan and defined contribution plan fractions exceeds 1.0, the Secretary of the Treasury is to issue regulations under which the numerator of the new defined contribution plan fraction (as determined for the last year beginning before January 1, 1983) will be reduced, so that the sum of the new fractions does not exceed 1.0. The fresh start rule does not apply, however, with respect to individuals for whom the sum of the defined benefit plan and defined contribution plan fractions exceeded 1.4 (as determined under the rules in effect before the amendments made by the Act).

With respect to a plan maintained on September 3, 1982, pursuant to one or more collective bargaining agreements, the reduction provided for by the regulations is to be made to the numerator of the defined contribution plan fraction as determined for the last year beginning before the earlier of (i) the date on which the last of the collective bargaining agreements terminates or (ii) January 1, 1986.

2. Loans to plan participants (sec. 236 of the bill and sec. 72 of the Code)

Prior Law

Qualified pension, etc., plans

A qualified pension, etc., plan generally is permitted to make a loan to a plan participant if certain requirements are met. Generally, under present law and prior law, the loan must bear a reasonable rate of interest, be adequately secured, provide a reasonable repayment schedule, and be made available on a basis which does not discriminate in favor of employees who are officers, shareholders, or highly compensated (sec. 4975(d)). However, a qualified plan benefitting a self-employed individual (an H.R. 10 plan) is not permitted to lend to an owner-employee (a sole proprietor or a partner whose partnership interest exceeds 10 percent), and a plan of an electing small business corporation (a subchapter S corporation) is not permitted to lend to a shareholder-employee (an employee owning more than 5 percent of the corporation's stock). Also, under prior law, if a self-employed individual (whether or not an owner-employee) participating in an H.R. 10 plan borrowed from the plan or used an interest in the plan as security for a loan, the transaction was treated as a plan distribution and the usual income tax rules for distributions applied.

Loans are also permitted under tax-sheltered annuity contracts, including custodial accounts investing in stock of a regulated investment company.

IRAs

If an individual borrows from an IRA or uses amounts in an IRA as security for a loan, the transaction is treated as a distribution and the usual income tax rules for IRA distributions apply (secs. 72(m) and 408(e)). Rules corresponding to the IRA provisions apply with respect to loans from accumulated deductible employee contributions under an employer's plan and to the use of the accumulated contributions as security for a loan (sec. 72(o)).[1]

Reasons for Change

Congress was concerned that widespread use of loans from tax-qualified plans and tax-sheltered annuities diminishes retirement savings and thereby undercuts the objective of encouraging retirement savings. Accordingly, Congress concluded that restrictions on loans and pledges should be applied to all plan participants. Congress was also concerned, however, that an absolute prohibition against loans might discourage retirement savings by rank-and-file employees who may need access to such monies for emergencies.

---

[1] For taxable years beginning after 1981, an employee is allowed a deduction for voluntary contributions to a plan if certain requirements are met (sec. 219). The annual deduction is limited to the lesser of $2,000 or 100 percent of the employee's compensation, and is in lieu of the deduction allowed for contributions to an IRA.

Also, see H.R. 6056, Technical Corrections Act of 1982: House floor amendments, 128 Cong. Rec. H9600-9604; H. Rep. No. 97-986 (Dec. 21, 1982), pp. 29-30 (Joint Explanatory Statement of the Committee of Conference).

Explanation of Provision

Loans treated as distributions

The Act leaves unchanged the prior-law rules treating as distributions loans from IRAs or from accumulated deductible employee contributions under employer plans. Under rules added by the Act, any amount received (directly or indirectly) by a participant as a loan from (1) a qualified pension, etc., plan (including a plan that was at any time determined to be or was treated as a qualified plan), (2) a governmental plan (whether or not a qualified plan), or (3) a tax-sheltered annuity contract (including a custodial account investing in stock of a regulated investment company) will also be treated as a distribution to the participant unless certain requirements are met. For purposes of these rules, any amount received (directly or indirectly) as a loan under a contract purchased under a qualified plan, etc. (including a contract which has been distributed to the participant) is treated as a loan from the plan under which the contract was purchased. However, if a premium which is otherwise in default is paid in the form of a loan against the contract, the loan is not considered made to the participant unless the contract has been distributed to the participant.

In addition, if a participant assigns (or agrees to assign) or pledges (or agrees to pledge) any portion of the participant's interest in a qualified plan, etc. (or in a contract purchased under such a plan), such a portion generally is treated as having been received by the participant as a loan from the plan. However, if all or a portion of a participant's interest in a plan is pledged or assigned as security for a loan to the participant from the plan, only the amount of the loan, and not the amount pledged or assigned, is taken into account as a loan from the plan.

The Act's loan rules generally apply to loan transactions involving a beneficiary under the plan on the same basis as they apply to loan transactions involving an employee-participant. Of course, for purposes of the distribution rules, a loan made with respect to an employee-participant which is received by a beneficiary of the participant is treated as an amount received by the participant, if the participant is alive at the time the loan is treated as a distribution.

Limitation with respect to loan amounts

Under the Act, a loan that, by its terms, is to be repaid within 5 years generally is treated as a distribution to the extent that the amount of the loan, when added to the outstanding loan balance (principal plus interest) with respect to the employee under all plans of the employer exceeds the lesser of (1) $50,000, or (2) one-half of the present value of the employee's nonforfeitable accrued benefit under such plans. However, no loan is treated as a distribution under this provision to the extent that the amount of the loan, when added to the outstanding loan balance with respect to the employee, totals $10,000 or less. Under the Act, the outstanding loan balance with respect to an employee includes unpaid amounts under loans which were outstanding on August 13, 1982.

If, immediately after a loan is made, an employee's outstanding loan balance does not exceed one-half of the present value of the employee's nonforfeitable accrued benefit, the loan will not be treated as a distribution merely because of a subsequent decrease in that present value (including a decrease on account of a distribution made to the employee). To determine the loan limit with respect to a participant, and to determine the participant's outstanding loan balance, plans of separate employers whose employees are treated as employed by a single employer under the pension, etc., plan rules (sec. 414) are treated as plans of a single employer.

Limitation with respect to repayment period

Any loan made with respect to an employee under a qualified plan, etc., which is not required to be repaid within 5 years generally is treated as a distribution. For this purpose, the period within which a loan is required to be repaid is determined at the time the loan is made. If a repayment period of less than 5 years is subsequently extended beyond 5 years, the balance payable under the loan at the time of the extension is to be treated as distributed at the time of the extension. In addition, if payments under a loan with a repayment period of not more than 5 years are not in fact made, so that an amount remains payable after the end of 5 years, the amount remaining payable at the end of 5 years is treated as if distributed at the end of the 5-year period. A loan which is treated as a distribution on account of a repayment period of more than 5 years will not be treated as other than a distribution merely because it is repaid within 5 years (whether by reason of a renegotiation of the payment period or otherwise). If there are required periodic payments, the first of which is due to be made within two months of the date the loan was made, then five-year repayment period will be measured from the due date of that first payment.

The Act provides an exception to the 5-year repayment rule to the extent that a loan made with respect to a plan participant is applied toward acquiring, constructing, or substantially rehabilitating any house, apartment, condominium, or mobile home (not used on a transient basis) which is used or is to be used within a reasonable time as the principal residence of the participant or a member of the participant's family. Under the Act, determination as to whether a dwelling is to be used as a principal residence of the participant or dependent is to be determined at the time the loan is made. For purposes of the Act's loan rules, any rehabilitation which is a qualified rehabilitation within the meaning of section 103A(l)(7) (relating to mortgage subsidy bonds) is a substantial rehabilitation.

Application of distribution rules

The usual income tax rules for distributions from qualified pension plans, etc., will apply to loan amounts which are treated as distributions under the Act's provisions.[2] Under the distribution rules, a recipient is deemed to receive first any nondeductible contributions under the plan. Thus, a loan amount which is treated as a distribution is includible in the recipient's gross income only to the extent that such amount exceeds the net amount of nondeductible employee contributions under the plan under which the loan is made.

For example, if a plan participant with respect to whom the loan amount limitation is $50,000 (*i.e.*, the present value of the participant's vested accrued benefits is at least $100,000) also has contributed $15,000 of nondeductible employee contributions to the plan, the Act would not cause a loan from the plan of up to $65,000 to be a taxable distribution (the first $15,000 treated as a distribution would be considered a distribution of employee contribution). In the case of a $70,000 loan which is repayable within 5 years, for example, the only amount includible in the participant's income under the new rules is $5,000 ($70,000—($50,000+$15,000)). Of course, the example assumes that, at the time of the $70,000 loan, no other loans were outstanding with respect to the employee under the plans of the employer, and no previous distributions to the participant were treated under the distribution rules as a return of the employee's nondeductible contributions.

A failure to pay loan interest when due will constitute an indirect loan for purposes of the Act unless, under the facts and circumstances, such a failure does not constitute an additional loan transaction. Similarly, with regard to a loan amount outstanding on August 13, 1982, a failure to repay loan principal when due will constitute an indirect loan for purposes of the Act unless, under the facts and circumstances, the failure does not constitute an additional loan transaction.

Loan repayments

Repayments of loans (including loans treated as distributions) will not be considered employee contributions for purposes of those rules limiting nondeductible employee contributions and annual additions on behalf of an employee under qualified plans and tax-sheltered annuity contracts (sec. 415) or those rules allowing the employee a deduction for certain voluntary contributions under an employer's plan (sec. 219).

For purposes of the income tax rules for taxation of distributions, repayments of amounts previously treated as distributions and included in gross income under the new loan rules are to be treated as nondeductible employee contributions. Under this rule, a distribution of amounts consisting of loan repayments where the loan was treated as a distribution and that distribution was included in gross income will not be included in gross income again. Accordingly, the participant is not taxed on the same amount when a loan is treated as a distribution and again when the repaid amount is distributed.

---

[2] However, a loan which constitutes a distribution is not eligible for the special 10-year income averaging rules, long-term capital gain treatment, deferral of capital gain, or tax-free rollover treatment otherwise available to certain distributions under tax-qualified plans or tax-sheltered annuities.

Under the Act, it is possible for a loan amount which is treated as a distribution to exceed the participant's accrued benefits under the plan under which the loan is made. If, the treatment of a loan as a distribution causes the participant's basis with respect to the plan to exceed the amount of the final distribution made to the participant under the plan, then the participant may recognize a loss with respect to such final distribution.

Plan qualification

The Act makes no changes to the prior-law prohibited transaction rules (sec. 4975(e)) and fiduciary standards for qualified pension, plans, etc. Thus, the Act does not revise prior-law provisions requiring that a plan loan bear a reasonable rate of interest, be adequately secured, provide a reasonable repayment schedule, and be made available on a basis which does not discriminate in favor of employees who are officers, shareholders, or highly compensated.

Although the Act changes the tax treatment of certain plan loans, it does not modify the tax-qualification standards of the Code for pension, profit-sharing, or stock bonus plans or the non-Code rules of ERISA. For example, the tax qualification of a plan is not adversely affected under the amendments made by the Act merely because an amount is treated as distributed to a participant under this provision at a time when the plan is not permitted to make a distribution to the participant.

Similarly, the status of a custodial account investing in stock of a regulated investment company (sec. 403(b)(7)) is not adversely affected on account of a loan being treated as a distribution under the Act.

Of course, where a loan would be treated as a distribution under prior law, the Act does not change the prior-law results with respect to either the income tax consequences to the individual or the effect of the distribution upon the qualification of the plan making the distribution.

Loans to self-employed individuals and shareholder-employees

The Act does not revise the prior-law rules (sec. 4975(d)) under which a loan to an owner-employee under an H.R. 10 plan or to a shareholder-employee under a qualified plan of a subchapter S corporation is considered a prohibited transaction subject to certain excise tax sanctions. Similarly, the Act does not revise the prior-law qualification rules (sec. 401(a)(13)) under which a loan which is a prohibited transaction may be a prohibited assignment or alienation of plan benefits. However, the Act repeals, for plan years beginning after December 31, 1983, the rule under which an H.R. 10 plan generally was precluded from paying benefits to an owner-employee (including payments in the form of a loan made to the owner-employee) before the owner-employee attains age 59½.

The Act repeals, for loans made after August 13, 1982, those rules under which any loan made to a self-employed individual (whether or not an owner-employee) under an H.R. 10 plan is treated as a distribution to the individual under the income tax rules. Under the Act, the new loan rules are applied with respect to loans to self-employed individuals under H.R. 10 plans on the same basis as the new rules are applied with respect to loans to common-law employees.

Certain mortgage loans

Under the Act, investments (including investments in residential mortgages) which are made in the ordinary course of an investment program will not be considered as loans if the amount of the mortgage loan does not exceed the fair market value of the property that is purchased with the loan proceeds and subject to the mortgage. An investment program exists, for example, when trustees determine that a specific percentage or amount of plan assets will be invested in residential mortgages under specified conditions. However, mortgage loans made as a result of the direction of investments of an individual account will not be considered as made under an investment program and no loan which benefits an officer, director, or owner (or their beneficiaries) will be treated as an investment.

The Act's provisions do not otherwise affect the prior-law rules relating to whether a transaction is a loan made with respect to a plan participant or an investment of plan assets.

Effective Date

In general

The Act's provisions generally apply to loans made after August 13, 1982. For this purpose, a commitment to make a loan is not a loan, and an amount disbursed after August 13, 1982, pursuant to a loan commitment in effect on that date is treated as a loan made on the date of the disbursement. Loan amounts outstanding on August 13, 1982, which are renegotiated, extended, renewed, or revised after that date, generally are to be treated as loans made on the date of the renegotiation, etc. For this purpose, a scheduled change in the interest rate charged on a loan balance (*e.g.*, a variable rate contract), or a mere transfer of a loan from one plan of an employer to another, will not be treated as a revision or renegotiation of the loan. If a loan outstanding on August 13, 1982, is renegotiated, etc., after that date, the 5-year repayment requirement is satisfied with respect to the amount subject to the renegotiation, etc., if such amount is repayable (and is repaid) within 5 years after the renegotiation, etc.

Qualified refunding loans

Under a special transitional rule, a qualified refunding loan made after August 13, 1982, and before August 14, 1983 (including a demand loan outstanding on August 13, 1982) generally will not be treated on the date of the loan as a distribution under the Act's provisions. A qualified refunding loan is a loan used to make a required principal repayment on a loan which was outstanding on August 13, 1982, if that repayment is required to be made before August 14, 1983. Any amount outstanding under a qualified refunding loan on August 14, 1983, is treated under the Act's provisions as a loan made on that date.

A renegotiation, etc., of a loan outstanding on August 13, 1982, is treated as a qualified refunding loan made on the date of the renegotiation, etc., to the extent that the rules relating to qualified refunding loans are met with respect to amounts subject to the renegotiation, etc. Thus, amounts subject to such a renegotiation, etc., are a qualified refunding loan only to the extent that such amounts include repayments of principal which were originally (*i.e.*, on August 13, 1982) required to be made before August 14, 1983.

3. Parity under the qualified plan rules for corporate and noncorporate employers; Group-term life insurance (Secs. 237–250 of the Act and Secs. 72, 79, 101, 219, 269A, 401, 404, 405, 408, 414, 415, 416, and 1379 of the Code)

Prior Law

Plans for self-employed individuals

Under prior law and present law, a pension or profit-sharing plan is not a qualified plan unless it is established by an employer for the exclusive benefit of employees or their beneficiaries. For this purpose, a sole proprietor is considered both an employee and an employer, and a partnership is considered the employer of each partner.

A qualified plan which benefits a self-employed individual (a sole proprietor or partner) is referred to as an "H.R. 10 plan" or "Keogh plan." Under prior law, these plans were subject to special rules which were in addition to the other qualification requirements of the Code. These special rules included limits on the contributions and benefits which could be provided for a self-employed individual and also limits on the amount of an individual's compensation which could be taken into account under the plan. The same or corresponding limits also applied to qualified plans of subchapter S corporations (subchapter S plans) and to simplified employee pensions (SEPs). These limits were generally lower than the overall limits on contributions and benefits applicable with respect to all employees under qualified plans.

Limits on contributions and benefits

Under a qualified profit-sharing or other defined contribution H.R. 10 plan, annual deductible contributions on behalf of a self-employed individual generally were limited by prior law to the lesser of $15,000 or 15 percent of net earnings from self-employment (sec. 404(e)).

Under a defined benefit H.R. 10 pension plan, the annual benefit accruals for a self-employed individual were limited by a special schedule designed to permit the accrual of an annual pension benefit no greater than that which could be provided by the accumulated annual contributions on behalf of a self-employed individual permitted under a defined contribution H.R. 10 plan (sec. 401(j)).

Under a defined contribution subchapter S plan, annual employer contributions on behalf of a shareholder-employee (an employee who owns more than five percent of the corporation's stock) in excess of the annual deduction limit (the lesser of $15,000 or 15 percent of compensation) were includible in the income of the shareholder-employee (sec. 1379(b)). Under a defined benefit subchapter S pension plan, benefits were limited under the same schedule that applied to a defined benefit H.R. 10 pension plan. In addition, if a self-employed individual or shareholder-employee participated in both a defined contribution plan and a defined benefit plan maintained by the same employer, the aggregate of the contributions and benefits under the plans could not exceed the limit for such an individual who participated in only one such plan (sec. 401(j)(1)).[1]

If an individual retirement account or individual retirement annuity qualifies as a simplified employee pension (SEP), prior law increased the annual IRA deduction limit. Under prior law, the limit was increased by the lesser of $15,000 or 15 percent of compensation (sec. 408(j)). Under prior law and present law, the increased deduction limit for a SEP applies only to employer contributions.

Under prior law, the limits for H.R. 10 plans, subchapter S plans, and SEPs were not automatically adjusted for cost-of-living increases.

Limit on includible compensation

Under the additional qualification rules of prior law for H.R. 10 plans, subchapter S plans, and SEPs, only the first $200,000 of an employee's compensation could be taken into account (sec. 401(a)(17)).

If a defined contribution H.R. 10 plan, subchapter S plan, or a SEP took into account compensation in excess of $100,000, contributions on behalf of a participant generally could not be made at a rate of less than 7.5 percent of the participant's compensation. A corresponding rule, generally requiring a minimum annual benefit accrual for each employee, applied with respect to a defined benefit H.R. 10 or subchapter S pension plan under which compensation in excess of $100,000 was taken into account. However, the amount actually contributed or the benefit actually accruing for a participant under a plan or a SEP could be less if the plan was integrated with social security.

In addition, contributions on behalf of any owner-employee (a sole proprietor or partner whose partnership interest exceeds 10 percent) under an H.R. 10 plan could be made only with respect to the earned income which was derived from the trade or business with respect to which the plan was established (sec. 401(d)(11)).

Special tax-qualification rules for H.R. 10 plans benefitting owner-employees

In addition to prescribing tax-qualification requirements generally applicable to all plans, prior law required that if an H.R. 10 plan benefitted an owner-employee, then the plan was also required to meet special standards providing employees additional security. The special standards included rules relating to (1) coverage, (2) vesting, (3) distributions, (4) integration with social security, (5) employee contributions, (6) plan trustees, and (7) employers under common control. They also imposed limitations with respect to an owner-employee which did not apply to a shareholder-employee under a subchapter S plan or to a partner under an H.R. 10 plan whose partnership interest does not exceed 10 percent.

---

[1] Under the Subchapter S Revision Act of 1982 for years beginning after 1982, an employee owning more than two percent of the corporation's stock is treated as a shareholder employee.

Coverage standards

Overview

The qualification rules (sec. 410(b)) require that a plan cover employees in general rather than merely the employer's top-ranking employees. A plan generally satisfies the coverage rule of present law and prior law if (1) it benefits a classification of employees that does not discriminate in favor of employees who are officers, shareholders or highly compensated, or (2) it benefits a significant part of the employer's work force. A plan can meet the second coverage test if (1) it benefits at least 70 percent of all employees, or (2) it benefits at least 80 percent of the employees eligible to benefit under the plan and at least 70 percent of all employees are eligible.

Special H.R. 10 rules

If an H.R. 10 plan benefitted an owner-employee, the qualification rules of prior law generally required that the plan benefit all employees with at least three years of service with the employer (sec. 401(d)(3)(A)). However, contributions and benefits could not be provided for an owner-employee under an H.R. 10 plan unless the owner-employee consented to being included under the plan (sec. 401(d)(4)(A)).

Vesting standards

Overview

To insure that employees with substantial periods of service with the employer do not lose plan benefits upon separation from employment before retirement, the qualification rules of prior law and present law generally require that a plan meet one of three alternative minimum vesting schedules (sec. 411). Under these schedules, an employee's right to benefits derived from employer contributions becomes nonforfeitable (vested) upon completion of specified periods of service with an employer.

Under one of the schedules, full vesting is required upon completion of 10 years of service but no vesting is required before the end of the 10th year. Under a second schedule, vesting begins at 25 percent after completion of five years of service and increases gradually to 100 percent after completion of 15 years of service. The third schedule takes both age and service into account, but in any event requires 50-percent vesting after 10 years of service and an additional 10-percent vesting each year thereafter until 100-percent vesting is attained after 15 years of service.

Benefits or contributions under a qualified plan must not discriminate in favor of employees who are officers, shareholders, or highly compensated. Because turnover among rank-and-file employees tends to be higher than turnover for officers, etc., it has been recognized that vesting more rapid than is required by ERISA may be necessary under the tax law to prevent discriminatory forfeitures by the rank-and-file in favor of officers, etc. A plan is not required to provide a vesting schedule faster than that required under the minimum vesting standards unless (1) there has been a pattern of discriminatory abuse under the plan (such as dismissal of employees before their benefits vest), or (2) there has been, or there is reason to believe there will be, a discriminatory accrual of benefits or a discriminatory pattern of forfeitures (sec. 411(d)(1)).

Special H.R. 10 rules

If an H.R. 10 plan benefitted an owner-employee, the tax-qualification rules of prior law (sec. 401(d)) required that an employee's rights to benefits derived from employer contributions under the plan be nonforfeitable at the time the contributions were paid (*i.e.*, the plan was required to provide full and immediate vesting).

Distributions of plan benefits

Overview

Under the qualification rules of present law and prior law, unless an employee otherwise elects in writing, the payment of plan benefits generally must begin no later than 60 days after the end of the plan year in which the employee attains the normal retirement age under the plan (or age 65, if earlier). The payment of benefits may be deferred beyond normal retirement age (or age 65), if the employee has not yet separated from the employer's service or has not yet completed 10 years of plan participation (sec. 401(a)(14)).

Benefits under a qualified plan must be for the primary benefit of an employee rather than the employee's beneficiaries. Under the rule limiting incidental death benefits, benefits generally must be payable to the employee at a rate such that more than 50 percent of the total benefits for the employee are payable to the employee over the employee's life expectancy. However, in any case, payments may be made over the joint life expectancy of the employee and the employee's spouse.

A qualified pension plan generally may not distribute plan benefits before (1) the employee retires or otherwise separates from the service of the employer, (2) the employee becomes disabled, or (3) the plan terminates.

Special H.R. 10 rules

Under the prior law additional qualification rules for H.R. 10 plans, the payment of benefits to an owner-employee was required to begin not later than the taxable year in which the owner-employee attained age 70½ (sec. 401(a)(9)). The payment of benefits to a plan participant who was not an owner-employee could be delayed beyond the taxable year in which the participant attained age 70½, if the participant had not yet retired. Benefits under an H.R. 10 plan were required to be paid at least as rapidly as ratably over the life of the employee (or the joint lives of the employee and the employee's spouse), or over a period not extending beyond the employee's life expectancy (or the joint life expectancy of the employee and the employee's spouse).

In addition, if an owner-employee died before his entire interest had been distributed, the entire remaining balance generally had to be distributed to his beneficiaries within 5 years or be used within that period to distribute an immediate annuity contract to the beneficiaries (sec. 401(d)(7)).

Under the qualification rules of prior law, an H.R. 10 plan generally had to provide that no benefits could be paid to an owner-employee before the owner-employee attained age 59½ or was disabled (sec. 401(d)(4)). However, the plan was not precluded from distributing to an owner-employee an amount not in excess of the employee contributions made by the owner-employee to the plan.

If an owner-employee received a distribution from an H.R. 10 plan prior to attaining age 59½ or becoming disabled, the amount of the distribution includible in gross income was subject to an additional 10-percent income tax (sec. 72(m)(5)). In addition, unless the distribution was made on account of termination of the plan and was rolled over, tax-free, to an IRA, no contributions could be made to an H.R. 10 plan on behalf of the owner-employee for the five taxable years following the taxable year of the distribution (sec. 401(d)(5)).

Loans to plan participants

Overview

A qualified pension, etc., plan generally is permitted under present law and prior law to make a loan to a plan participant if certain requirements are met. Generally, the loan must bear a reasonable rate of interest, be adequately secured, provide a reasonable repayment schedule, and be made available on a basis which does not discriminate in favor of employees who are officers, shareholders, or highly compensated (sec. 4975(d)).

Special H.R. 10 rules

An H.R. 10 plan is not permitted under present law or prior law to lend to an owner-employee and a subchapter S plan is not permitted to lend to a shareholder-employee. In addition, under prior law, if a self-employed individual (whether or not an owner-employee) participating in an H.R. 10 plan borrowed from the plan or used an interest in the plan as security for a loan, the transaction was treated as a plan distribution and the usual income tax rules for distributions applied.

Integration with social security

Overview

Under prior law and present law, a qualified pension, etc., plan may be integrated with social security. Under an integrated plan, an employee's plan benefits may be reduced by taking into account social security benefits deemed to be provided by the employer. The prior law rules for integrating a defined contribution plan of a corporate employer, or an H.R. 10 plan which did not benefit an owner-employee, allowed an employer to reduce plan contributions for an employee by an amount equal to seven percent of the employee's wages subject to the tax imposed on the employer under the Federal Insurance Contributions Act (FICA). Corresponding rules permit an employer to integrate a defined benefit pension plan with social security.

Special H.R. 10 rules

H.R. 10 plans generally are defined contribution plans. Under prior law, annual contributions for an employee under a defined contribution H.R. 10 plan which benefitted an owner-employee, could be reduced by a portion of the FICA tax imposed on the employer with respect to the employee's wages for the year, if (1) the limit on plan contributions for the owner-employee was reduced by the self-employment tax imposed on the owner-employee, and (2) not more than one-third of the deductible contributions to the plan for the year were made on behalf of owner-employees (sec. 401(d)(6)). For 1982, the FICA tax imposed on an employer with respect to each employee was equal to 5.4 percent of the first $32,400 of the employee's wages. The tax on self-employment income was equal to 8.05 percent of the first $32,400 of such income.

No integration with social security was permitted under prior law in a defined benefit plan which benefitted an owner-employee.

Employee contributions

Overview

A qualified plan may provide for contributions by the employer, by the employees, or both. In many cases, the employee contributions are mandatory (*i.e.,* required as a condition of employment, a condition of participation in the plan, or a condition of obtaining additional employer-derived benefits). In other cases, employee contributions are voluntary, and the amount, within limits, is left to the discretion of the employee. A plan can provide for both mandatory and voluntary employee contributions.[2]

Under prior law and present law, contributions or benefits under a qualified plan must not discriminate in favor of employees who are officers, shareholders, or highly compensated. Because highly compensated employees may be more able than rank-and-file employees to contribute to a plan, the nondiscrimination rule imposes limits on employee contributions, whether mandatory or voluntary.

Voluntary employee contributions generally may not exceed 10 percent of the employee's compensation. The limit is applied on a cumulative basis (*i.e.,* with respect to an employee's compensation for all years of plan participation). Deductible employee contributions under the plan are not taken into account for purposes of the limitation on voluntary employee contributions.

The Internal Revenue Service has held that mandatory employee contributions may cause prohibited discrimination if they result in precluding participation by lower paid employees (*i.e.,* where the contributions are required as a condition of plan participation) or in disproportionately low benefits for such employees (*i.e.,* where the contributions are required as a condition of obtaining additional employer-derived benefits).[3]

---

[2] For taxable years beginning after 1981, an employee is allowed a deduction for voluntary contributions to a plan if certain requirements are met (sec. 219). The annual deduction is limited to the lesser of $2,000 or 100 percent of the employee's compensation and is in lieu of the deduction allowed for contributions to an IRA.

[3] The Service's position was announced in Rev. Rul. 80-307, 1980-2 C.B. 136, which superseded Rev. Rul. 72-58, 1972-1 C.B. 111. The earlier Revenue Ruling provided that, as a general rule, contributions required at a rate of six percent of compensation would not be considered burdensome on lower paid employees. The six-percent guideline was not renewed in Rev. Rul. 80-307.

Special H.R. 10 rules

Under prior law, an H.R. 10 plan which benefitted an owner-employee could not provide for mandatory employee contributions (Treas. Reg. § 1.401-12(e)(1)). In addition, if an H.R. 10 plan benefitted only owner-employees, nondeductible voluntary employee contributions were also precluded (sec. 4972). If an H.R. 10 plan which benefitted owner-employees also benefitted other employees, voluntary nondeductible contributions by an owner-employee were limited to the smallest of (1) $2,500, (2) 10 percent of the owner-employee's earned income from self-employment, or (3) the amount which would have been contributed by the owner-employee if such contribution were made at the rate of contributions permitted employees other than owner-employees.

Annual contributions under a plan that benefitted a self-employed individual in excess of the combined limits on deductible and (if permitted) nondeductible contributions were subject to a six-percent nondeductible excise tax, unless the excess (plus earnings) was withdrawn before the due date (including extensions) for filing the owner-employee's income tax return for the taxable year.

Trustees of qualified plans

The tax-qualification rules generally do not preclude employees or officers of an employer from serving as trustees of a trust forming a part of the employer's qualified pension, etc., plan. However, with respect to an H.R. 10 plan which benefitted an owner-employee, prior law required that the trustee be a bank or other financial institution approved by the Secretary of the Treasury (sec. 401(d)(1)).

Definite formula

A profit-sharing plan must generally provide that contributions be made out of present or accumulated profits. Although the plan must provide a definite formula for allocating contributions among the participants, no definite contribution formula generally is required. However, a profit-sharing plan benefitting an owner-employee was required by prior law to provide a definite formula for determining the contributions to be made on behalf of employees other than owner-employees (sec. 401(d)(2)(B)).

Aggregation of employers

Overview

For purposes of the qualification rules of prior law and present law for pension, etc., plans, all employees of corporations which are members of a controlled group of corporations, or all employees of trades and businesses (whether or not incorporated) which are under common control, are aggregated and treated as if employed by a single employer (sec. 414 (b) and (c)). In addition, special aggregation rules also apply with respect to the employees of certain service organizations and related employers (sec. 414(m)).

Special H.R. 10 rules

Under additional rules of prior law (sec. 401(a) (9) and (10)) applicable to an H.R. 10 plan which benefitted an owner-employee (or owner-employees), all employees of all unincorporated trades or businesses controlled by the owner-employee (or owner-employees) were treated as if employed by a single trade or business for purposes of the H.R. 10 qualification rules. An owner-employee, or two or more owner-employees, were considered to control an unincorporated trade or business if, alone or together, they owned more than 50 percent of either the capital or profit interest in such trade or business.

Employer-provided life, health, and accident insurance

Under prior law and present law, the first $5,000 paid by or on behalf of an employer by reason of an employee's death generally is excluded from the income of the employee's beneficiaries or estate, if certain requirements are met (sec. 101(b)). This income exclusion for employer-provided death benefits is also generally applied to the first $5,000 paid as a lump sum distribution or, under certain circumstances, as a joint and survivor annuity under a qualified pension, etc., plan. However, under prior law, no income exclusion for employer-provided death benefits was available with respect to amounts paid on behalf of a self-employed individual, including amounts paid under an H.R. 10 plan.

Amounts contributed by an employer to a qualified pension, etc., plan to provide incidental life, health, or accident insurance to employees covered by the plan generally are deductible (within limits) when made. However, no deduction is allowed for contributions to an H.R. 10 plan on behalf of a self-employed individual to the extent that the contributions were allocable to the purchase of such insurance (sec. 404(e) (3)).

An amount applied under a qualified pension, etc., plan to purchase life insurance protection for a participant is includible in the participant's income for the taxable year when so applied (sec. 72(m)(3)). Amounts so included in a participant's income generally are treated as amounts contributed by the participant under the plan, and may be recovered, tax-free, when benefits are paid under the plan (sec. 72(m)(2)). However, this rule for the tax-free recovery of amounts applied to purchase current life insurance protection does not apply to amounts applied under an H.R. 10 plan to purchase such protection for a self-employed individual.[4]

Reasons for Change

Congress believed that the level of tax incentives made available to encourage an employer to provide retirement benefits to employees should generally not depend upon whether the employer is an incorporated or unincorporated enterprise. Similarly, Congress believed that the rules needed to assure that the tax incentives available under qualified plans are not abused should generally apply without regard to whether the employer maintaining the plan is incorporated or unincorporated.

---

[4] Prior to the Economic Recovery Tax Act of 1981, the prohibition against the tax-free recovery of the cost of current life insurance protection applied only with respect to amounts paid on behalf of an owner-employee. The Act extended the rule to apply to amounts paid on behalf of all self-employed individuals under an H.R. 10 plan.

Congress concluded that the level of tax incentives should be the same for all employers who maintain qualified plans, with the exception of employers whose plans focus more than 90 percent of their benefits on key employees. In the case of these plans, a lower level of tax incentives was considered adequate.

In the case of plans under which more than 60 percent of the benefits are focused on key employees, Congress concluded that special rules are needed to assure that the rank-and-file employees would receive the benefits that the tax incentives were provided to encourage.

Explanation of Provisions

Overview

The Act generally eliminates distinctions in the tax law between qualified pension, etc., plans of corporations and those of self-employed individuals (H.R. 10 plans). The Act (1) repeals certain of the special rules for H.R. 10 plans, (2) extends other of the special rules to all qualified plans, including those maintained by corporate employers, and (3) generally applies the remainder of the special rules, with modifications, only to those plans (whether maintained by a corporate or noncorporate employer) which favor the employer's key employees (top-heavy plans). The top-heavy plan rules are provided in addition to the usual rules for plan qualification and the treatment of distributions.

The special rules for H.R. 10 plans which are repealed include those which (1) set lower limits on contributions and benefits for self-employed individuals, (2) preclude an H.R. 10 plan benefitting an owner-employee plan from limiting coverage to a fair cross section of employees, and (3) preclude integrating such a plan with social security benefits. The corresponding limitations applicable to subchapter S plans and SEPs are also repealed.

The special rules for H.R. 10 plans which are extended to all qualified plans relate to (1) distributions made to the employee or to the employee's beneficiaries after the employee's death, and (2) integration of a defined contribution plan with social security.

The special rules for H.R. 10 plans which generally are extended (with modifications) to plans of corporate and noncorporate employers which favor key employees (top-heavy plans) include those rules relating to (1) includible compensation, (2) vesting (alternative schedules are provided) and (3) distributions. The rules for a top-heavy plan also require that such a plan provide a non-key employee a nonintegrated minimum benefit or a nonintegrated minimum contribution, and in some cases reduce the overall limits on contributions and benefits for a key employee who is covered by more than one plan of an employer.

These provisions apply for years beginning after December 31, 1983.

Repeal of rules for H.R. 10 plans

Deductible contributions and permitted benefit accruals

The Act generally repeals the special deduction limits (sec. 404(e) (1), (2), and (4)) for contributions on behalf of a self-employed individual under an H.R. 10 profit-sharing plan. Under the Act, the maximum amount of employer contributions and other annual additions for a self-employed individual is determined pursuant to the overall limits on contributions and benefits (sec. 415) rather than the employer deduction rules. Thus, annual additions for a self-employed individual equal to the lesser of 25 percent of the individual's compensation [5] or $30,000 generally are permitted (sec. 415(c)). The employer's deduction for plan contributions continues to be limited under the usual rules for deductions (sec. 404).

No change is made to the prior-law rules under which no deduction is allowed for contributions to an H.R. 10 plan on behalf of a self-employed individual to the extent that the contributions are allocable to the purchase of incidental life, health, or accident insurance (sec. 404(e)(3)), or under which a self-employed individual generally is denied a basis in amounts applied under an H.R. 10 plan to purchase life insurance protection for the individual (sec. 72(m)(2)).

In addition, the Act repeals the special qualification rules for a defined benefit H.R. 10 plan or subchapter S plan (sec. 401(j)). Such defined benefit plans will be subject to the rules applicable to defined benefit plans maintained by corporate employers. One result is that a self-employed individual or shareholder-employee may be provided pension benefits based upon past service (*i.e.*, service with the employer before the plan was established), subject of course to rules precluding discrimination in favor of officers, shareholders, or highly compensated employees.

Repeal of the special rules under section 401(j) also permits a self-employed individual or shareholder-employee who participates in both a defined benefit plan and a defined contribution plan of the same employer increased aggregate contributions and benefits, as determined under the overall limits on contributions and benefits under qualified plans (sec. 415(e)). In addition, beginning in 1986, cost-of-living adjustments will also apply to the dollar limits applicable to an H.R. 10 plan, to a subchapter S plan, or to a SEP.

Earned income

For purposes of the pension rules, the Act revises the definition of earned income of a self-employed individual so that the amount of earned income corresponds to the amount of compensation of a common-law employee. Under the Act, earned income is computed after taking into account contributions by the employer to a qualified plan to the extent a deduction is allowed for the contributions. Also, in this regard, no change is made to the prior-law rule (sec. 401(d)(11)) for owner-employees which has the effect of limiting the earned income which may be taken into account under the pension rules to that derived from the trade or business with respect to which the plan is established.

Coverage

The Act repeals the additional qualification requirement under which an H.R. 10 plan benefitting an owner-employee generally was required to benefit all employees who completed at least three years of service with the employer (sec. 401(d)(3)(A)).

---

[5] See discussion relating to earned income below.

The Act retains the special rules for H.R. 10 plans under which all employees of all unincorporated trades and businesses controlled by an owner-employee (or owner-employees) are treated as if employed by a single trade or business (sec. 401(d)(9) and (10)).

Employee contributions

The Act repeals the special rules precluding employer contributions under an H.R. 10 plan in excess of the deduction limit (sec. 401(d)(5)), and those rules limiting or precluding mandatory or voluntary employee contributions by an owner-employee (sec. 4972). The Act also repeals the six-percent excise tax on excess contributions made on behalf of an owner-employee.

Miscellaneous restrictions

The following special H.R. 10 plan rules are also repealed:

(1) the requirement that a profit-sharing plan provide a definite contribution formula for employees who are not owner-employees (sec. 401(d)(2)(B));

(2) the requirement that an owner-employee must consent to participate (sec. 401(d)(4)(A));

(3) the requirement that the plan trustee be a bank or other approved financial institution (sec. 401(d)(1));

(4) the prohibition against contributions on behalf of an owner-employee for the five taxable years following an early withdrawal by the owner-employee (sec. 401(d)(5)(C));

(5) the denial of the $5,000 income exclusion for death benefits paid with respect to a self-employed individual under the plan (sec. 101(b)); and

(6) the rules treating any loan made to a self-employed individual as a distribution under the plan (sec. 72(m)).

Nothing in the Act requires that an H.R. 10 plan delete provisions establishing a definite formula, requiring consent, or providing for a bank trustee. For example, an employer may prefer that an H.R. 10 plan continue to provide that an owner-employee must consent to participate, thereby permitting an owner-employee to elect against plan participation.

Extension of certain H.R. 10 rules to all plans

Required distributions

The Act extends to all qualified plans the requirement that a participant's benefits must be distributed not later than (1) the taxable year in which the participant attains age 70½, or (2) if later, the year in which the participant retires (sec. 401(a)(9)). Alternatively, distributions must begin no later than such taxable year and must be made, pursuant to regulations prescribed by the Secretary of the Treasury, over the life of the participant (or lives of the participant and the participant's spouse), or over a period not exceeding the life expectancy of the participant (or the life expectancies of the participant and the participant's spouse). Distributions made pursuant to the regulations may be made to the participant and a non-spouse beneficiary, although the measuring lives remain those of the participant and the participant's spouse. Of course, as under prior law, distributions are required whether or not the participant applies for benefits.

In addition, the Act extends to all qualified plans certain rules for post-death distributions. If a participant dies before the entire interest is distributed, amounts payable to a beneficiary who is not the participant's surviving spouse generally must be paid to the beneficiary within 5 years after the participant's death. However, if distribution has commenced under a schedule which, consistent with the Act's requirements, takes into account the life or life expectancy of the participant's spouse, the beginning of 5-year period is determined by reference to the date of the participant's death or the spouse's death, whichever is later.

The rules requiring that post-death distributions to a non-spouse beneficiary be made within 5 years do not apply if distribution has commenced and is payable over a term certain which does not exceed the participant's life expectancy or the life expectancy of the participant and the participant's spouse.

Benefits payable to a participant's surviving spouse are not required to be paid to the spouse within 5 years after the participant's death, without regard to whether distribution has commenced to the participant before the participant's death. If the distribution has not commenced to the participant before the participant's death, amounts payable to a beneficiary after the death of the participant's surviving spouse generally must be paid to the beneficiary within 5 years after the spouse's death, unless distribution has commenced to the spouse and is payable over a term certain not exceeding the spouse's life expectancy.

The requirement that all amounts be paid to a beneficiary within 5 years after the participant's death (or the death of the participant's spouse) may not be met by the distribution of an immediate annuity contract to the beneficiary within the 5-year period. The Act continues the incidental death benefit rule.

Although these required distribution rules generally apply for plan years beginning after December 31, 1983, a special transition rule exempts certain distributions made pursuant to employee designations. Under the transition rule, a plan's qualified status is not adversely affected merely because it provides for distributions which do not satisfy the Act's distribution rules (including those rules requiring that distributions to a key employee in a top-heavy plan commence no later than the year in which the key employee attains age 70½), provided that (1) the method of distribution satisfies the distribution rules in effect prior to the Act (including rules relating to incidental death benefits), and (2) the distributions are made pursuant to an employee designation made before January 1, 1984. The transition rule applies to both pre-death and post-death distributions and without regard to the date that the distributions commence.

Inherited IRAs

The Act also revises the rules (sec. 408) relating to distributions from an individual retirement account or annuity (IRA) after the death of the individual on whose behalf the IRA was established. The rules for post-death distributions from IRA's generally parallel those rules added by the Act for post-death distributions from qualified plans. Accordingly, the requirement that all amounts in an IRA generally be distributed to beneficiaries within five years after the individual's death (or the death of the individual's surviving spouse) may no longer be met by the distribution of an immediate annuity contract within the 5-year period.

In addition, the Act repeals those rules under which any beneficiary of an individual on whose behalf an IRA was established (or any beneficiary of the surviving spouse of such an individual) could effectively elect to treat the IRA as one established on the beneficiary's own behalf. (See Treas. Reg. § 1.408-2(b)(7)(ii)) Under the Act, if an individual (other than the decedent's surviving spouse) inherits an IRA from a decedent, no amount may be rolled over to or from the IRA, and no deduction is allowed to the individual for contributions to the IRA. The Act's rules relating to inherited IRAs also apply to individual retirement bonds (sec. 409).

The provisions relating to post-death IRA distributions apply with respect to individuals dying after December 31, 1983. The provisions relating to inherited IRAs apply to taxable years beginning after December 31, 1983, with respect to IRAs inherited from individuals dying after that date.

Integration with social security

The Act extends to all qualified defined contribution plans (including target benefit plans) a prior-law H.R. 10 rule under which the tax rate and wage base applicable to employers for old age, survivors, and disability insurance (OASDI) under social security are the maximum rate and base for determining the amount by which employer contributions can be reduced under plans that are integrated with social security. This provision is designed to decrease the extent of integration in defined contribution plans without increasing the extent of integration in any plan.

For 1982, the employer's tax rate with respect to OASDI benefits under social security is 5.4 percent, and the taxable wage base is the first $32,400 of an employee's pay. Thus, if the provisions were applicable for 1982, a profit-sharing plan could provide contributions of 5.4 percent of 1982 pay in excess of $32,400 and no contributions for 1982 with respect to the first $32,400 of pay. Similarly, if a plan provided for 1982 contributions of 10 percent of pay in excess of $32,400, it would integrate only if it provided for 1982 contributions of at least 4.6 percent (10% minus 5.4%) with respect to the first $32,400 of pay. The same rules apply to contributions on behalf of a self-employed individual. As under prior law, a plan may provide an integration level (*i.e.,* wage level) which is less than the taxable wage base or, if the rate at which the plan is integrated is properly adjusted (*i.e.,* to a rate less than the full OASDI tax rate), an integration level which is higher than the taxable wage base.

The wage base and tax rates which apply for any plan year are the wage base and tax rates in effect on the first day of the plan year.

The remaining prior-law rules which restricted integration with social security under an H.R. 10 defined contribution plan which benefitted an owner-employer are repealed.

Additional qualification requirements for top-heavy plans

Overview

Under the Act, additional qualification requirements are provided for plans which primarily benefit an employer's key employees (top-heavy plans). These additional requirements (1) limit the amount of a participant's compensation which may be taken into account, (2) provide greater portability of benefits for plan participants who are non-key employees by requiring more rapid vesting, (3) provide minimum nonintegrated contributions or benefits for plan participants who are non-key employees, and (4) reduce the aggregate limit on contributions and benefits for certain key employees. Further, additional restrictions are placed on distributions to key employees.

Top-heavy plans

Under the Act, a defined benefit pension plan is a top-heavy plan for a plan year if, as of the determination date, the present value of the cumulative accrued benefits for participants who are key employees for the plan year exceeds sixty percent of the present value of the cumulative accrued benefits for all employees under the plan. A defined contribution plan is a top-heavy plan for a plan year if, as of the determination date, the sum of the account balances of participants who are key employees for the plan year exceeds sixty percent of the sum of the account balances of all employees under the plan. In addition, a plan is top heavy if it is required to be a part of an aggregation group and the group is top heavy. Generally, in computing a participant's account balance as of a determination date, the account balance as of the preceding valuation date would be increased by the amount of (1) employee contributions, (2) forfeitures, and (3) employer contributions which had been made and actually allocated on or before the determination date. In addition, the account balance for a participant in a money purchase pension plan generally would be increased by amounts required to be allocated on or before the determination date, whether or not those amounts had been actually contributed prior to that date.

Under the top-heavy plan rules, a simplified employee pension is considered a defined contribution plan. At the election of the employer, the account balance of any employee covered by a simplified employee pension is deemed to be the sum of the employer contributions made on the employee's behalf.

The determination date for any plan year generally is the last day of the preceding plan year. However, in the case of the first plan year of a plan, the determination date is the last day of that year. Further, to the extent provided in regulations, the determination date may be determined on the basis of a year other than a plan year.

Top-heavy groups

The Act also provides rules under which two or more plans (including terminated plans) of a single employer are aggregated to determine whether the plans, as a group, are top-heavy. The aggregation group is required to include (1) any plan which covers a key employee (including a plan maintained pursuant to a collective bargaining agreement) and (2) any plan upon which a plan covering a key employee depends for qualification under the Code's coverage or antidiscrimination rules (secs. 401(a)(4) or 410). In addition, in testing for top-heaviness, an employer may elect to expand the aggregation group to take into account any other plan maintained by the employer (including benefits considered to be provided to its employees under a plan maintained by more than one employer) if such expanded aggregation group satisfies the coverage and antidiscrimination rules in the aggregate.

An aggregation group is a top-heavy group if, as of the determination date, the sum of (1) the present values of the cumulative accrued benefits for key employees under any defined benefit plans included in the group, and (2) the account balances of key employees under any defined contribution plans included in the group, exceeds 60 percent of the same amount determined for all participants under all plans included in the group. If an aggregation group is a top-heavy group, then each plan required to be included in the group is a top-heavy plan. If the aggregation group is not a top-heavy group, then no separate plan included in the group is top-heavy even though, standing alone, the plan would be top heavy. Of course, no plan included in the aggregation group at the election of the employer is subject to the top-heavy plan rules on account of the election. In addition, the top-heavy rules relating to vesting, minimum benefits or contributions, and includible compensation do not apply with respect to an employee included in a unit of employees covered by a collective bargaining agreement, if retirement benefits were the subject of good faith bargaining between employee representatives and the employer.

The top-heavy group rules apply to all plans of related employers which are treated as a single employer (sec. 414).

Additional rules

For purposes of determining the present value of accumulated accrued benefits under a defined benefit pension plan and the sum of the account balances under a defined contribution plan, benefits derived from both employer contributions and employee contributions generally are taken into account. In addition, amounts payable under a plan to a beneficiary of an employee (whether a key employee or a non-key employee) are to be taken into account under the computation as benefits payable to the employee. However, accumulated deductible employee contributions under a plan (sec. 72(o)(5)) are to be disregarded.

In addition, to insure relative stability and to preclude distortions under the top-heavy plan computation, the present value of the cumulative accrued benefit of a participant in a defined benefit pension plan or the account balance of a participant in a defined contribution plan generally includes any amount distributed with respect to the participant under the plan within the five-year period ending on the determination date (including lump-sum distributions and distributions made before enactment or before the plan became top-heavy).

The actuarial assumptions used to determine the present value of cumulative accrued benefits under a defined benefit pension plan must be reasonable in the aggregate. If an aggregation group includes two or more defined benefit plans, the same actuarial assumptions must be used with respect to all such plans. In addition, only mortality and interest may be taken into account in determining present values.

A rollover contribution (or similar transfer) made after December 31, 1983, generally is not taken into account under the transferee plan for purposes of the top-heavy plan computation. This rule of exclusion does not apply if the contribution (or transfer) is made incident to a merger or consolidation of two or more plans or the division of a single plan into two or more plans. In addition, the exclusion does not apply to rollover contributions (or transfers) between plans of the same employer, including plans of related employers which are treated as a single employer (sec. 414). Of course, in any case in which a rollover contribution or transfer (including a contribution or transfer made before January 1, 1984) is required to be taken into account under the transferee plan, the amount distributed by a related transferor plan is not also taken into account under the transferor plan.

If an employee is a key employee with respect to a determination date, the total amount of the employee's accrued benefit under a defined benefit plan or account balance under a defined contribution plan (including amounts attributable to service as a non-key employee) is taken into account under the top-heavy computation as an amount for a key employee. However, if an employee is a non-key employee with respect to a determination date, but was a key employee with respect to a prior determination date, the total amount of the employee's accrued benefit or account balance is disregarded under the top-heavy computation. Thus, if an employee is a key employee on any date during the plan year within which the employee separates from the service of the employer (*e.g.*, by reason of retirement or death), the accrued benefit or account balance for the employee is to be taken into account under the top-heavy computation as an accrued benefit or account balance for a key employee, but only with respect to a determination date falling within the plan year of the separation or the four following plan years. With respect to subsequent determination dates the accrued benefit or account balance for the employee is disregarded (unless the employee returns to the service of the employer as a key employee).

Key employees

An individual is a key employee of an employer if the individual is (1) an officer (in the case of a corporate employer), (2) is one of the 10 employees owning the largest interests in the employer, (3) owns more than a 5-percent interest in the employer, or (4) owns more than a 1-percent interest in the employer and has compensation from the employer in excess of $150,000. An individual is a key employee with respect to a determination date (and for the plan year for which the determination is made) if the individual was a key employee on any day during the plan year that includes the determination date or any one of the four preceding plan years (including plan years ending before enactment of the Act and plan years for which the plan is not top-heavy).

Under the Act, an individual is considered as owning more than a five-percent interest in a corporate employer if the employee owns more than five percent of the employer's outstanding stock or stock possessing more than five percent of the total combined voting power of all stock of the employer. An individual is also treated as owning stock owned by certain members of the individual's family or, in certain cases, by partnerships, estates, trusts, or corporations in which the individual has an interest (sec. 318). The same rules apply to determine whether an individual is a one-percent owner.

In the case of an employer that is not a corporation, ownership is determined in accordance with regulations prescribed by the Secretary of the Treasury. The regulations are to be based on principles similar to the principles of section 318. In addition, to determine whether a self-employed individual who is a one-percent owner is a key employee, compensation means earned income (as redefined by the Act) from the trade or business.

In determining which individuals are to be treated as key employees as a result of their one-percent or five-percent ownership interests (but not for purposes of determining the top-10 employee-owners), ownership is tested separately with regard to each employer. For this purpose, the aggregation rules of section 414 (b), (c) and (m) do not apply. The aggregation rules of section 414 (b), (c), and (m) apply, however, for the purpose of determining whether an individual who is a one-percent owner is a key employee because of compensation in excess of $150,000.

In determining which individuals are to be treated as key employees as a result of their status as officers, the relationship between the individual and the employer (determined without regard to the aggregation rules of section 414 (b), (c), and (m)) is determinative. However, in no event will more than 50 employees of an employer (or, if lesser, the greater of 3 employees or 10 percent of all employees) be treated as key employees because of officer status with respect to any determination date. For purposes of applying this limit, the aggregation rules of section 414 (b), (c), and (m) are to apply. If an employer has more officers than the number required to be counted as key employees, the officers to be taken into account are those with the highest compensation during the year which includes the determination date.[6]

Qualification rules

These additional rules for top-heavy plans are tax-qualification requirements. Thus, a top-heavy plan is a qualified plan, and a trust forming part of a top-heavy plan is a qualified trust, only if the additional requirements are met. In addition, except as the Secretary of the Treasury may provide by regulations, a plan (whether or not top-heavy in fact) will constitute a qualified plan only if the plan includes provisions which meet the additional qualification requirements for top-heavy plans and which will automatically take effect if the plan becomes a top-heavy plan. It is expected that the Treasury regulations will not require the inclusion of top-heavy plan rules in a collectively bargained plan that covers no key employees.

---

[6] As under prior law, the determination as to whether an employee is an officer is to be determined upon the basis of all the facts and circumstances, including, for example, the source of the employee's authority, the term for which elected or appointed, and the nature and extent of the employee's duties. As generally accepted in connection with corporations, the term "officer" means an administrative executive who is in regular and continued service. It implies continuity of service and excludes those employed for a special and single transaction, or those with only nominal administrative duties. Thus, for example, all the employees of a bank who have the title of vice president or assistant vice president would not automatically be considered to be officers. Nor would the mere absence of a title preclude the determination that an individual with true executive authority is, in fact, an officer. See, for example, Rev. Rul. 80-314, 1980-2 C.B. 152.

Includible compensation

For any plan year for which a plan is a top heavy plan, only the first $200,000 of any employee's compensation may be taken into account under the plan. Beginning in 1986, this $200,000 limit will be adjusted under the same rules used to adjust the overall dollar limits on contributions and benefits. Of course, no previously accrued benefit may be reduced as a result of a cost-of-living increase in the $200,000 limit. For purposes of the $200,000-rule, in the case of a self-employed individual, compensation means earned income as redefined by the Act.

A top-heavy plan may continue to provide for benefits based on compensation in excess of $200,000 to the extent such benefits were accrued in years when the plan was not top-heavy. In addition, for purposes of the percentage of compensation limits under the overall limits on contributions and benefits (sec. 415), all compensation (including that in excess of $200,000) is taken into account.

Vesting

For any plan year for which a plan is a top-heavy plan, an employee's right to the accrued benefit derived from employer contributions must become nonforfeitable (sec. 411(a)) under a vesting schedule which satisfies one of two alternative schedules. The vesting schedules apply to all accrued benefits under the plan (including benefits accrued before the top-heavy rules apply) whether or not the accrued benefits are required by the top-heavy plan rules and whether or not they accrued while the plan was top heavy.

A plan satisfies the first alternative vesting schedule (three-year, full vesting) if a participant who has completed at least three years of service with the employer or employers maintaining the plan has a nonforfeitable right to 100 percent of the accrued benefit derived from employer contributions. As under prior law, a plan which provides three-year, 100 percent vesting will not fail to satisfy the participation requirements (sec. 410(a)(1)) merely because it requires completion of three years of service as a condition of participation.

A plan will satisfy the second alternative vesting schedule (six-year, graded vesting) if a participant has a nonforfeitable right to at least 20 percent of the accrued benefit derived from employer contributions at the end of two years of service, 40 percent at the end of three years of service, 60 percent at the end of four years of service, 80 percent at the end of five years of service, and 100 percent at the end of six years of service with the employer. No exception is provided for class year plans. Thus, a class year plan which is top-heavy (or a part of a top-heavy group) must provide that all plan benefits vest pursuant to one of the two top-heavy vesting schedules.

Generally, for purposes of determining service under these vesting schedules, the present-law rules (sec. 411) relating to years of service, breaks in service, and certain permitted forfeitures, etc., apply except to the extent the rules of section 411 are inconsistent with the purposes of section 416. Accordingly, all years of service with the employer generally are to be taken into account, including years of service completed prior to the enactment of the Act, and service during periods for which a plan is not a top-heavy plan.

A top-heavy plan which ceases to be top heavy may provide a vesting schedule slower than that required under the top-heavy rules. Of course, the vested percentage of each participant's benefit accrued as of the end of the last top-heavy year could not be reduced, and any employee with at least five years of service with the employer could elect to remain subject to the top-heavy vesting schedule (sec. 411(a)(10)).

Minimum nonintegrated benefit for non-key employees

A qualified pension, etc., plan which is a top-heavy plan must provide a minimum benefit or contribution derived from employer contributions for each employee who is a participant in the plan and who was not a key employee with respect to the determination date.

Under the Act, any individual who is excluded from coverage under a plan because of compensation below a specified amount, or because the individual declined to make mandatory contributions, or any individual considered a participant for purposes of the coverage requirements (secs. 401(a)(5) and 410) must be provided the applicable minimum contribution or benefit.

A defined benefit plan satisifies this minimum benefit requirement if, on a cumulative basis, the accrued benefit of each participant who is not a key employee, when expressed as an annual retirement benefit, is not less than two percent of the employee's average annual compensation from the employer during the employee's testing period, multiplied by the employee's years of service with the employer. However, an employee's minimum benefit is not required to exceed 20 percent of such average annual compensation. All years of an employee's service otherwise required to be taken into account under the plan (sec. 411(a)), generally are required to be taken into account under the minimum benefit rules, except a year of service (1) completed in a plan year beginning before January 1, 1984, or (2) within which ends a plan year for which the plan is not a top-heavy plan. For example, a year in which an employee does not complete a year of service with the employer (*i.e.,* 1,000 hours) need not be taken into account in determining years for which the two-percent minimum is required.

For purposes of the minimum benefit rules, only benefits derived from employer contributions (other than amounts employees have elected to defer (*e.g.* under a cash or deferred arrangement)) to the plan are taken into account, and an employee's social security benefits are disregarded. Thus, the required minimum benefit for an employee may not be eliminated or reduced on account of the employee's social security benefits attributable to contributions by the employer (*i.e.*, the minimum benefit is a "nonintegrated" benefit).

The term annual retirement benefit is defined as a benefit payable annually in the form of a single life annuity (with no ancillary benefits) beginning at the normal retirement age. An employee's testing period used to determine average annual compensation is the period of the employee's consecutive years of service (not exceeding five) during which the employee had the greatest aggregate compensation from the employer. However, a year of service (and compensation paid to the employee during such year) need not be included in the employee's testing period if it ends in a plan beginning before January 1, 1984, or begins within or after the last plan year for which the plan is a top-heavy plan.

Minimum nonintegrated contribution for non-key employees

For a plan year for which a defined contribution plan is a top-heavy plan, the employer generally must contribute on behalf of each plan participant who is not a key employee for the year an amount not less than three percent of the participant's compensation. The minimum contribution must be made for each year in which the plan is top-heavy. Thus, the required minimum contribution may not be reduced or eliminated on account of prior plan contributions merely because the participant's account balance exceeds an amount equal to 3 percent multiplied by the number of years for which the plan is top-heavy. Each participant who is not a key employee for the year is entitled to the minimum contribution if the participant is in service on the allocation date under the plan. For example, a non-key employee who participates in a top-heavy thrift plan that provides for matching employer contributions may be entitled to a 3 percent minimum contribution whether or not the employee contributes to the plan on his own behalf.

If the employer's contribution rate for each participant who is a key employee for the plan year is less than three percent, the required minimum contribution rate for each non-key employee generally is limited to not more than the highest contribution rate for any key employee. For example, if, under a profit-sharing plan, no amount is contributed by the employer for any key employee, then under this limitation no contribution is generally required under the minimum contribution rules for any non-key employee. Under the minimum contribution rules, reallocated forfeitures are taken into account as employer contributions for key employees and non-key employees.

The limitation to the rate of contributions for key employees does not apply with respect to a defined contribution plan upon which a defined benefit plan depends for qualification under the Code's coverage or antidiscrimination rules (secs. 401(a)(4) or 410) if the defined benefit plan benefits a key employee (or if a plan which benefits a key employee also depends upon the defined benefit plan for qualifications (sec. 401(a)(4) or sec. 410)). Under these circumstances, the required minimum contribution rate for a non-key employee is in every case three percent even if the contribution rate on behalf of a key employee is less than 3 percent. For purposes of the limitation, and for purposes of the minimum contribution rules generally, all defined contribution plans of the employer are considered a single plan.

To determine the contribution rate for an employee (including a key employee), the employer contributions and reallocated forfeitures on behalf of the employee for the year under all defined contribution plans maintained by the employer are divided by the employee's total compensation (or, with respect to a self-employed individual, the individual's earned income (as redefined by the Act)) from the employer for the year, not to exceed $200,000.

Amounts paid by the employer for the year to provide social security benefits for the employee are disregarded. Thus, the required minimum contribution for a non-key employee may not be eliminated or reduced on account of benefits attributable to taxes paid by the employer under social security (*i.e.*, the minimum contribution is a "nonintegrated" contribution). Similarly, the employer contribution rate for a key employee is determined without regard to employer contributions under social security. For example, if a plan is integrated with social security by providing key employees with employer contributions equal to 5 percent of compensation in excess of $32,400, the contribution rate for a key employee whose total compensation is $50,000 is 1.76 percent ((0.05×$17,600)÷$50,000).

No required duplication of minimum benefit or minimum contribution

Under the Act, the Treasury is to prescribe rules to preclude inappropriate omissions or required duplications of minimum benefits or contributions. If a non-key employee participates in both a defined benefit plan and a defined contribution plan included in a top-heavy group, the employer is not required by the Act to provide the non-key employee with both the full, separate minimum benefit and the full, separate minimum contribution. Thus, larger total benefits generally should not be required merely because an employee is covered under more than one plan. For example, if an employee participates in a top-heavy money purchase pension plan that provides an annual nonintegrated contribution rate of 5 percent of compensation (which is determined to be equivalent to the value of the minimum benefit in a defined benefit plan under the rules for computing actuarial equivalence) and a defined benefit plan that provides an annual benefit of 1 percent of pay, the employer would not be required to provide an additional 1-percent benefit for non-key employees participating in the defined benefit plan. It is also anticipated that these rules would preclude an employee who is covered under more than one plan from receiving lower benefits or contributions than that employee would receive if covered under a defined benefit plan only or a defined contribution plan only.

Of course, contributions or benefits for a non-key employee under any one or all plans included in a top-heavy group may otherwise be required (for example, by reason of the nondiscrimination rules). In any case in which separate plans are required to be considered together for purposes of the coverage or nondiscrimination rules, the required minimum benefit or minimum contribution may, of course, be taken into account. However, two plans are not necessarily comparable merely because one plan provides the required minimum benefit while the other provides the required minimum contribution. Similarly, the fact that two plans both provide the required minimum benefit, or that two plans both provide the required minimum contribution, does not insure that the two plans, as a whole, are comparable.

Aggregate limit on contributions and benefits for key employees

The Act includes additional rules with respect to the aggregate limit on benefits and contributions (sec. 415(e)) for a key employee who participates in both a defined benefit plan and a defined contribution plan that are included in a top-heavy group. Unless certain requirements are met, for any year for which the plans are included in the top-heavy group, the new defined benefit plan and defined contribution plan fractions are modified, effectively providing the key employee with an aggregate limit equal to the lesser of 1.0 (as applied only to the dollar limits) or 1.4 (as applied to the percentage limits).

Under the Act, the denominator of the modified defined benefit fraction is the lesser of (i) the dollar limit in effect for that year (or, if greater, that participant's current accrued benefit), or (ii) 1.4 multiplied by the amount of compensation which may be taken into account for that year under the applicable percentage limit. The denominator of the modified defined contribution fraction is the sum of the lesser of the following amounts, computed separately for each year of service with the employer: (i) the dollar amount for that year, or (ii) 1.4 multiplied by applicable percentage limit. Corresponding revisions are made to the defined contribution transition fraction.

In some cases, the aggregate of a key employee's accrued benefit under an employer's defined benefit plans and annual additions under the employer's defined contribution plans computed using the modified defined benefit plan and defined contribution plan fractions may exceed 1.0 at the time the key employee is first required to use the modified fractions to compute the aggregate limit. In such a case, the key employee is permitted no further benefit accruals under the defined benefit plans and no additional employer contributions, reallocated forfeitures, or voluntary nondeductible employee contributions under the defined contribution plans until the sum of the defined contribution and defined benefit fractions is less than 1.0. However, the Act's "fresh start" transitional rule applies. (See 1. Limits on contributions and benefits, Effective date, Transitional rules, Aggregate limit.)

These modifications do not apply if the plans of the employer in which the key employee participates (1) meet the requirements of the concentration test, and (2) provide either an extra minimum benefit (in the case of the defined benefit plan) or an extra minimum contribution (in the case of the defined contribution plan) for non-key employees participating in the plans. The extra contribution or benefit is non-integrated and is in addition to the minimum contribution or benefit required for all top-heavy plans.

The concentration test is generally satisfied with respect to a key employee for a year if the plan is not more than 90 percent top heavy.

The requirement for an extra minimum benefit for non-key employees is satisfied for a year if, in addition to the minimum benefit otherwise required in a defined benefit plan, for the plan year ending with or within such year, the additional accrued benefit of each non-key employee who is a participant is not less than the lesser of (1) one percent of the employee's average annual compensation, multiplied by the employee's years of service with the employer, or (2) 10 percent of such average annual compensation. This extra minimum benefit generally is determined in the same manner as the minimum benefit required under the rules for a top-heavy defined benefit plan. However, for purposes of the extra minimum benefit, a year of service is required to be taken into account only if (1) such year of service includes the last day of a plan year for which the plan is a top-heavy plan (or included in a top-heavy group), and (2) such plan year ends with or within a year for which the aggregate limit of the key employee exceeds 1.0 under the modified fractions.

In a defined contribution plan,. the requirement for an extra minimum contribution is satisfied for a year if, for the plan year ending with or within such year, the employer contributes on behalf of each non-key employee who is a participant an extra amount (in addition to the usual minimum contribution) that is not less than one percent of the employee's compensation for the year.

Distributions to key employees

The Act also provides new rules for distributions from top-heavy plans to key employees. If a distribution is made to an individual who is (or was) a key employee before attaining age 59½, an additional income tax generally is imposed on that portion of the distribution attributable to accumulations or accruals made when he was a key employee in a top-heavy plan. The amount of the tax is equal to 10 percent of the amount includible in income, unless the distribution is made on account of death or disability. This tax applies whether or not the plan is top-heavy at the time of the distribution, but it applies only to accumulations attributable to periods of service as a key employee in a top-heavy plan. Thus, accumulations attributable to periods when an employee was not a key employee or when the plan was not top-heavy (including pre-1984 accumulations formerly subject to a similar penalty imposed accumulations attributable to service as an owner-employee) are not subject to the additional 10 percent tax. In addition, as under prior law, no tax is imposed on distributions that are rolled over tax free, to an IRA.

In addition, a top-heavy plan must provide that distributions to an individual who is a key employee in a top-heavy plan at the time he attains age 70½ will commence not later than the taxable year in which the key employee attains age 70½, whether or not he separates from service in that year and whether or not he applies for benefit payment. The distribution must begin no later than that taxable year and must be completed pursuant to regulations prescribed by the Secretary of the Treasury within a period based on the life of the participant (or lives of the participant and his spouse), or over a period of years not exceeding the life expectancy of the participant (or the life expectancies of the participant and his spouse). Distributions made pursuant to the regulations may be made to the participant and a non-spouse beneficiary, although the measuring lives remain those of the participant and the participant's spouse. Of course, a plan will not lose its qualified status merely because distributions to a key employee do not satisfy this rule, provided (1) the method of distribution satisfies the distribution rules in effect prior to the Act (including those rules limiting incidental benefits), and (2) the distributions are made pursuant to an employee designation made before January 1, 1984.

Organization performing management functions

The Act expands the class of employees who, under the present-law rules for affiliated service groups (sec. 414(m)), are to be treated as employed by a single employer for purposes of certain of the tax-law rules for qualified pension, etc., plans (including the rules for top-heavy plans), cafeteria or medical reimbursement plans, or simplified employer pensions (SEPs). Under the provision, if an organization's principal business is performing, on a regular and continuing basis, management functions for one other organization, employees of the organization performing management functions and employees of the organization for which the management functions are performed are treated as employed by a single employer.

Under the provision, any employee of a person related to the organization performing the management functions is also included in the group that is treated as employed by a single employer as are the employees of an organization related to the organization for which the functions are performed. The provision does not change present law under which the aggregation of employers is otherwise required.

For purposes of the provision, the term "organization" includes an individual, a corporation, a partnership, etc. Whether organizations are related is determined under present-law rules (sec. 103(b)(6)(C)).

Congress intended that the provision is to apply only where the management functions performed by one person for another are functions historically performed by employees, including partners or sole proprietors in the case of unincorporated trades and businesses. For this purpose, the present-law rules relating to affiliated service organizations and to services historically performed by employees in the case of an affiliated service organization are to apply.

Employee leasing

The Act also provides that, for purposes of certain of the tax-law rules for qualified pension, etc., plans (including the rules for top-heavy plans) and SEPs, an individual (a leased employee) who performs services for another person (the recipient) treated as the recipient's employee where the services are performed pursuant to an agreement between the recipient and a third person (the leasing organization) who is otherwise treated as the individual's employer. Under the provision, the individual is to be treated as the recipient's employee only if the individual has performed services for the recipient (or for the recipient and persons related to the recipient) on a substantially full-time basis for a period of at least 12 months, and the services are of a type historically performed by employees in the recipient's business field. For this purpose, the prior-law rules relating to services historically performed by employees in the case of an affiliated service organization are to apply.

The employee leasing rules are not to apply where services in a particular business field historically have been performed by one person for another without an employee-employer relationship. For example, some prepaid health care service programs organized on a group practice basis involve two or three components: the health plan, a separate medical group that provides or arranges physicians' services to the health plan members, and often a related hospital. The hospital and the medical group each may employ its own staff (nurses, technicians, etc.), but both sets of employees may be jointly managed. Alternatively, the staff that supports the medical group may be employed by the health plan. These forms of operation are well established in the group practice prepaid health care field. Congress intended that, because these services are not historically performed by employees, the employee leasing rules will not apply in these cases (whether the form of operation is currently in effect or is put into effect for existing components of an established group practice prepaid health care service program or for the components of a new program) if the health plan, the hospital, and the medical group provide substantially similar, though not necessarily exactly equivalent retirement benefits through tax qualified plans to salaried non-union employees and partners.

For purposes of determining whether a pension, etc., plan or a SEP maintained by the recipient satisfies the applicable tax-law requirements, the leased employee is treated as the recipient's employee for periods after the close of the 12-month period. However, the leased employee's years of service (sec. 411(a)) for the recipient are determined by taking into account the entire period for which the leased employee performed services for the recipient (or for a related person).

Although this provision attributes certain leased employees to the recipient, no change is made to the present-law rules which also require that the leased employee be treated as an employee of the leasing organization (*i.e.* for purposes of testing the qualified status of any plan maintained by the leasing organization).

Under the provision, contributions or benefits for the leased employee which are provided by the leasing organization under a qualified plan or a SEP maintained by the leasing organization are to be treated as if provided by the recipient to the extent such contributions or benefits are attributable to services performed by the leased employee for the recipient.

The Act also includes a safe-harbor rule under which an individual who otherwise would be treated as a recipient's employee will not be treated as such an employee, if certain requirements are met with respect to contributions and benefits provided for the individual under a qualified money purchase pension plan maintained by the leasing organization. The safe harbor rule applies if the plan provides that (1) an individual is a plan participant on the first day on which the individual becomes an employee of an employer maintaining the plan, (2) each employee's rights to or derived from employer contributions under the plan are at all times nonforfeitable (sec. 411(a)), and (3) amounts are to be contributed by the employer on behalf of an employee at a rate not less than 7½ percent of the employee's compensation for the year (the 7½ percent contribution is not to be reduced by integration with social security). The safe harbor applies only for purposes of the employee leasing provision added by the Act (sec. 414(n)). If an individual is otherwise deemed an employee (*e.g.*, by reason of sec. 414(m)), the individual will continue to be treated as an employee for purposes of the enumerated employee benefit provisions.

For purposes of the provision, the term person includes individuals and organizations (corporations, partnerships, etc.). Whether persons are related persons is determined under present-law rules (sec. 103(b)(6)(C)).

The provision authorizes the Secretary of the Treasury to prescribe regulations under which a leased employee will not be treated as the recipient's employee, notwithstanding that the provision may otherwise apply. Under the Act, the Secretary is to prescribe such regulations where the Secretary determines that to treat a leased employee as the recipient's employee is not appropriate, taking into account the purposes underlying those qualified plan rules with respect to which the provision applies.

Certain corporations performing personal services

Under the Act, if a corporation, the principal activity of which is the performance of personal services substantially all of which are performed by employee-owners for or on behalf of another corporation, partnership, or entity (including related parties), is availed of for the principal purpose of evasion or avoidance of Federal income tax by securing for any employee-owner significant tax benefits which would not otherwise be available, then the Secretary may allocate all income, as well as such deductions, credits, exclusions, etc., as may be allowable, between or among the corporation and employee-owners involved.

For example, if a personal service corporation were formed or availed of for the principal purpose of utilizing the corporate surtax exemption or a fiscal year that would defer the payment of income tax, or both, then the Secretary could allocate income, etc., between the corporation and the employee-owners. On the other hand, no such allocation would be made if, under the facts and circumstances, the taxpayer can show that the principal purpose was not the avoidance or evasion of income tax.

For this purpose, an employee-owner is defined as any employee who owns (after application of the attribution rules under section 318) more than 10 percent of the outstanding stock of the corporation. Congress intended that the provisions overturn the results reached in cases like *Keller* v. *Commissioner,* 77 TC 1014 (1981), where the corporation served no meaningful business purpose other than to secure tax benefits which would not otherwise be available. The provision generally applies to taxable years beginning after December 31, 1982.

Effective for years beginning in 1984, the Act also eliminates most distinctions in the tax law between qualified retirement plans of corporations and qualified retirement plans of self-employed individuals. However, for 1983, when this provision affecting personal service corporations first applies, a corporation will be allowed contributions for its employees that are higher than the permitted contributions for self-employed individuals. Under the Act, Congress intended that a personal service corporation generally will not be considered to be formed or availed of for the purpose of evading or avoiding Federal income tax solely because, for 1983, the qualified plan rules will permit higher contributions and other advantages for corporate employees. Thus, in applying section 269A, for 1983, Congress intended that the Secretary of the Treasury generally will not take a corporation's qualified pension, etc., retirement plan into account.

Disincorporation relief

Congress understood that a number of personal service corporations, which were in existence on the date of enactment of the Act, may wish to liquidate when the parity provisions of the Act take effect. Therefore, a transitional rule is provided under which personal service corporations may, during 1983 or 1984, complete a one-month liquidation under section 333 of the Code without the risk that the corporation would incur tax on its unrealized receivables. Of course, the income represented by unrealized receivables will retain its character as ordinary income and will be fully recognized by the distributee shareholder upon subsequent collection or other disposition.

Group-term life insurance

The Act provides that the income exclusion for employer-provided group-term life insurance (sec. 79) will apply with respect to a key employee only if the life insurance is provided under a program of the employer that does not discriminate in favor of key employees as to (1) eligibility to participate, or (2) the life insurance benefits provided under the plan.

A program of an employer providing group-term life insurance for employees generally will not be considered to discriminate in favor of key employees as to eligibility to participate if (1) the program benefits at least 70 percent of all employees, (2) at least 85 percent of all participating employees are not key employees, or (3) the program benefits employees who qualify under a classification set up by the employer and found by the Secretary of the Treasury not to discriminate in favor of key employees. Alternatively, a program of an employer providing group-term life insurance which is provided under a cafeteria plan (sec. 125) will not be considered to discriminate in favor of key employees as to eligibility to participate if the eligibility rules for cafeteria plans are satisfied.

For purposes of the provision's rules relating to eligibility to participate, employees of certain related employers will generally be treated as if employed by a single employer. However, the following employees may be excluded from consideration: (1) those who have not completed 3 years of service with the employer, (2) part-time and seasonal employees, and (3) nonresident aliens who receive no U.S. source of income from the employer. For this purpose, part-time employees are those whose customary employment is for not more than 20 hours in any one week, and seasonal employees are those whose customary employment is for not more than 5 months in any calendar year. In addition, employees not covered by the program but covered by a collective bargaining agreement need not be taken into account if group-term life insurance was the subject of good faith bargaining between the employer and employee representatives.

A program of an employer providing group-term life insurance for employees will not be considered to discriminate in favor of key employees as to the benefits provided, if the program does not discriminate in favor of such employees with regard to the type and amount of the benefits. For this purpose, group-term life insurance benefits will not be considered to discriminate merely because the amount of life insurance provided employees bears a uniform relationship to compensation. Of course, the requirement that group-term life insurance benefits be nondiscriminatory can be satisfied where, under the facts and circumstances, no discrimination in favor of key employees occurs. For example, the requirement would be satisfied when the life insurance benefits are a level dollar amount which is the same for all covered employees.

Congress intended that the Secretary of the Treasury revise the tables for computing the amount includible in an employee's gross income on account of employer-provided group-term life insurance. Congress also intended that the tables be periodically revised to reflect current group-term life insurance costs.

Effective Date

The provisions relating to parity between corporate and noncorporate employers, top-heavy plans, organizations performing management functions, employee leasing, and group-term life insurance apply to years beginning after December 31, 1983.

The provisions relating to certain corporations performing personal services apply to taxable years beginning after December 31, 1982.

4. Retirement savings for church employees (sec. 251 of the Act and secs. 403 and 415 of the Code)

Prior Law

Subject to limits, public schools and certain tax-exempt organizations (including churches and certain organizations associated with churches) may make payments on behalf of an employee to purchase a tax-sheltered annuity contract (sec. 403(b)). Payments to a custodial account investing in stock of a regulated investment company (*e.g.*, a mutual fund) are also permitted. The amount paid by the employer is excluded from the employee's income for the taxable year to the extent that payment does not exceed the employee's exclusion allowance for the taxable year. The exclusion allowance is generally equal to 20 percent of the employee's includible compensation from the employer multiplied by the number of the employee's years of service with that employer, reduced by amounts already paid by the employer to purchase the annuity.

Employer payments to purchase a tax-sheltered annuity contract for an employee are also subject to the overall limits on contributions and benefits under qualified plans (sec. 415). Under the overall limits, annual additions [1] to tax-sheltered annuities and other defined contribution arrangements for the employee may not exceed the lesser of a specified dollar amount, or 25 percent of the employee's compensation from the employer for the year. Under a special rule (sec. 415(c)(4)(C)), an employee of an educational institution, hospital, or home health service agency may elect to compute the annual exclusion allowance for payments under a tax-sheltered annuity solely by reference to the maximum annual employer payment which could be made under the overall limit. Under prior law, this rule applied to employees of a church hospital, etc., but not to other church employees.

In addition, to allow certain lower-paid employees catch-up payments (*i.e.*, payments permitted under the exclusion allowance on account of prior years of service, but denied under the overall annual limit which takes into account only the current year), alternative special elections are provided to increase the overall limit for the year of the election. An individual is allowed only one of the special elections under section 415 during his lifetime. The first alternative catch-up election (sec. 415(c)(4)(A)) may be made only for the year of an employee's separation from the service of the contributing employer (the separation year catch-up election). The second alternative catch-up election (sec. 415(c)(4)(B)) generally may be made for any year, but is subject to limitations which the separation year catch-up election is not. Of course, neither election increases the amount excludable from the employee's income for the year under the exclusion allowance. Under prior law, the alternative catch-up elections were available to church and nonchurch employees of educational institutions, hospitals, and home health services, but not to other church employees.

---

[1] With respect to a tax-sheltered annuity, annual additions consist of employer contributions and certain employee contributions.

Reasons for Change

Congress concluded that the prior-law provisions relating to tax-sheltered annuities often made it difficult for churches to provide ministers and lay employees adequate retirement income. The prior-law formula for fixing an employee's annual exclusion allowance may not have reflected the career pattern of a minister or lay employee who moves from one employing organization to another within a church. In addition, the formula did not take into account the historically low salaries paid to ministers and other church employees.

Congress also concluded that the tax treatment of retirement savings provided church employees by an associated organization, such as a church pension board, should be clarified.

Explanation of Provision

Overview

The Act revises the prior-law rules relating to tax-sheltered annuity programs maintained by churches for their employees by generally increasing the ability of churches to provide retirement income for their employees and by clarifying the status of such programs under the tax law. For purposes of the Act's provisions, the term church includes a convention or association of churches, or an organization which is exempt from tax and is controlled by or associated with a church or a convention or association of churches. Church employees include duly ordained, commissioned, or licensed ministers and lay employees, including employees of tax-exempt organizations (whether civil law corporations or otherwise organized) which are controlled by or associated with a church.

Exclusion allowance increased

The Act generally increases the annual exclusion allowance for church employees whose adjusted gross income for the year does not exceed $17,000. Thus, an employee's eligibility for the increased exclusion allowance is determined by taking into account both includible compensation paid by the church and income from other sources. However, for this purpose an employee's adjusted gross income does not include income attributable to the employee's spouse.

Under the Act, the exclusion allowance for an eligible church employee is not less than the lesser of $3,000 or the employee's includible compensation for the year. Solely for the purpose of determining includible compensation under the special rule, the includible compensation of an eligible church employee who is a foreign missionary is considered to include the amount paid by the church during the taxable year for the purchase of a tax-sheltered annuity for the employee. A church employee is a foreign missionary for a taxable year for which the employee's principal duties are the propagation of religious doctrine or the performance of sacerdotal functions or humanitarian good works for the church outside the United States.

The Act also provides that for purposes of the exclusion allowance, all years of an employee's service with an organization that is a part of a particular church are treated as years of service with one employer. Thus, although a minister or lay employee may, during the span of a career with a church, transfer from one organization to another within the particular church, or from the church to an associated organization, all service with such organizations is treated as service with a single employer. Payments made by all such organizations on behalf of an employee are also to be taken into account under the exclusion allowance formula as contributions made by a single employer. While this rule applies for computing post-1981 exclusion allowances, pre-1982 service with, and pre-1982 payments by a particular church (as defined by the Act) are taken into account under the computations.

The Act makes available to all church employees the prior-law special elections permitted under the overall annual limit (sec. 415). The Act also permits a church employee an additional election pursuant to which the church may make payments for the year in excess of the otherwise applicable overall annual limit. The employee's election will increase the overall annual limit to the lesser of (1) the amount paid by the church for the year (plus any employee paid taken into account), or (2) $10,000. Employer payments permitted for a church employee under this provision (*i.e.*, payments in excess of the otherwise applicable annual limits) may not exceed $40,000 for the employee's lifetime. Of course, payments made pursuant to the election are excludable from the employee's income only if they are otherwise permitted under the employee's exclusion allowance for the taxable year. In addition, the election may not be made for the taxable year for which the separation year catch-up election is made.

Retirement income accounts maintained by churches

The Act also provides that generally the tax rules relating to tax-sheltered annuity contracts apply to retirement income accounts provided by a church for its employees. Under the Act, a retirement income account means a program which is a defined contribution plan (sec. 414(i)) and which is established or maintained by a church to provide retirement benefits for its employees under the tax-sheltered annuity rules. Thus, a church-maintained retirement income account differs from a tax-sheltered annuity only in that the account is not maintained by an insurance company. However, the Act also provides that a church-maintained retirement income program in existence on September 3, 1982, will not be considered as failing to satisfy the requirements for a tax-sheltered annuity (sec. 403(b)) merely because the program is a defined benefit plan (sec. 414(j)). For this purpose, a church-maintained retirement income program is considered to be in existence on September 3, 1982, notwithstanding that after that date the program is amended, otherwise modified, or extended to benefit other employees. In addition, if a church-maintained retirement income program which is otherwise a defined benefit plan provides a benefit which is based, in part, on the balance of a separate account of an employee, the separate account can qualify as a defined contribution plan for purposes of the rules relating to retirement income accounts.

The assets of a church-maintained retirement income account for the benefit of an employee or his beneficiaries may be commingled in a common fund made up of such accounts. However, that part of the common fund which equitably belongs to any account must be separately accounted for (*i.e.*, it must be possible at all times to determine the account's interest in the fund), and cannot be used for, or diverted to, any purposes other than the exclusive benefit of such employee and beneficiaries. Provided these requirements are met, the assets of a retirement income account also may be commingled with the assets of a tax-qualified plan without adversely affecting the status of the account or the qualification of the plan.

The assets of a church plan (sec. 414(e)) also may be commingled in a common fund with other amounts devoted exclusively to church purposes (for example, a fund maintained by a church pension board) if that part of the fund which equitably belongs to the plan is separately accounted for and cannot be used for or diverted to purposes other than for the exclusive benefit of employees and their beneficiaries. Of course, the reasonable costs of administering a retirement income account (including an account which is a part of a common fund) may be charged against the account. Such costs include the reasonable costs of administering a retirement income program of which the account is a part, including costs associated with informing employees and employers of the availability of the program. Any common fund is subject to the fiduciary standards (including the rules relating to prohibited transactions) of the Employee Retirement Income Security Act of 1974 if any participating trust is subject to those standards.

The Act also allows a church which maintains a tax-sheltered annuity, retirement income account, or pension plan a retroactive amendment period if the annuity, account, or plan is required to be amended by reason of any law, or any regulation, ruling, or other action under the tax laws. During the correction period, the annuity, account, or plan would be treated as satisfying the applicable tax-law requirement. To qualify for this treatment, the required amendment or other modification generally must be made not later than at the next earliest church convention. However, the Secretary of the Treasury may prescribe an alternative time period within which the required amendment is to be made. In this regard, the Secretary is to take into account that church governing bodies typically meet at lengthy intervals. Of course, in no event is the permitted correction period for a church to be less than that allowed under prior law (sec. 401(b)).

Effective Date

The provisions generally apply to taxable years beginning after December 31, 1981. The provisions relating to the overall limits apply to years beginning after that date. The retroactive amendment period rules apply as of July 1, 1982, and permit amendments to correct defects in existence on that date.

The provision relating to retirement income accounts provided by a church for its employees is effective for taxable years beginning after December 31, 1974.

5. Certain State judicial retirement plans (sec. 252 of the bill and sec. 131 of the Revenue Act of 1978)

Prior Law

Eligible State deferred compensation plan

Under prior law and present law (sec. 457(a)), employees of a State or local government or a rural electric cooperative are permitted to defer compensation under an eligible State deferred compensation plan if the deferral does not exceed prescribed annual limits (generally the lesser of $7,500 or 33⅓ percent of includible compensation). Amounts deferred by a participant in an eligible plan, plus any income attributable to the investment of such amounts, are includible in the income of the participant or the participant's beneficiary only when paid or otherwise made available under the plan.

Treatment of participants in an ineligible plan

If a deferred compensation plan of a State or local government fails to meet the requirements of an eligible plan, then all compensation deferred under the plan is includible currently in income by the participants unless the amounts deferred are subject to a substantial risk of forfeiture (sec. 457(e)). If amounts deferred are subject to a substantial risk of forfeiture, then they are includible in the income of participants or beneficiaries in the first taxable year in which there is no substantial risk of forfeiture.

This rule for the tax treatment of participants in an ineligible plan does not apply, however, if the tax treatment of a plan participant is governed by tax rules for the plan that are set forth elsewhere in the Code. For example, the rule does not apply if the ineligible plan is a qualified pension plan (sec. 401(a)), a tax-sheltered annuity program (sec. 403(b)), or includes a trust forming a part of a nonqualified pension plan (sec. 402(b)).

Reasons for Change

An eligible State deferred compensation plan is a defined contribution plan under which a plan participant is entitled to his account balance consisting of the deferred amounts plus earnings. Retirement plans for State judges are sometimes defined benefit plans under which a participant is entitled to a retirement benefit based upon the pay of sitting judges. Because the participant's benefit under such a plan generally does not depend upon the participant's account balance, Congress concluded that it is inappropriate to apply contribution limits or other rules designed for defined contribution plans.

Explanation of Provision

Under the Act, participants in a qualified State judicial plan are not subject to the rule requiring participants in a State deferred compensation plan that is not an eligible plan to include plan benefits in gross income when there is no substantial risk that the benefits will be forfeited (sec. 457(e)).

A State's retirement plan for the exclusive benefit of its judges or their beneficiaries is a qualified State judicial plan if (1) the plan has been continuously in existence since December 31, 1978, (2) all judges eligible to benefit under the plan are required to participate and to contribute the same fixed percentage of their basic or regular rate of compensation, and (3) a judge's retirement benefit under the plan is a percentage of the compensation of judges of the State holding similar positions.

In addition, the plan may not pay benefits with respect to a participant which exceed the limit on benefits permitted under qualified plans (sec. 415), and may not provide an option to plan participants as to contributions or benefits the exercise of which would affect the amount of the participant's currently includible compensation.

Effective Date

The provision applies to taxable years beginning after December 31, 1978.

6. Contributions for disabled employees (sec. 253 of the Act and secs. 404 and 415 of the Code)

Prior Law

In order to limit the extent to which individuals could use tax-favored arrangements to provide for retirement, the plan qualification rules (sec. 415) provide overall limits on contributions and benefits under qualified pension, etc., plans.

Under a profit-sharing or other defined contribution plan, the qualification rules provide an overall limit on the annual addition with respect to each plan participant (sec. 415(c)). Generally, the annual addition (consisting of employer contributions, certain employee contributions, and forfeitures allocated from the accounts of other participants) are limited to the lesser of (1) 25 percent of compensation for the year, or (2) $25,000 adjusted for cost-of-living increases (CPI) since 1974. The limit for 1982 was $45,475.

Because annual additions for an employee are limited to 25 percent of the employee's compensation, contributions generally may not be made on behalf of an employee who has separated from service.

Reasons for Change

Congress concluded that it is appropriate to increase the retirement income security of disabled employees by permitting an employer to make contributions to a profit-sharing or other defined contribution plan on their behalf.

Explanation of Provision

The Act permits an employer to elect to continue deductible contributions to a profit-sharing or other defined contribution plan on behalf of an employee who is permanently and totally disabled. An individual is considered permanently and totally disabled if the individual is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of at least 12 months.

Under the Act, annual additions with respect to a plan participant (consisting of employer contributions, certain employee contributions, and forfeitures) are limited to the lesser of (1) 25 percent of compensation or (2) $30,000. For purposes of the limit for defined contribution plans, the compensation of a disabled employee is deemed to be equal to the annualized compensation of the employee prior to the employee's becoming disabled.

In addition, the Act requires that the plan provide that disabled employees on whose behalf an employer elects to make contributions are to be fully and immediately vested in benefits derived from these contributions. Thus, where a disabled participant is not fully vested in the accrued benefits derived from other employer contributions, the plan will be required to maintain a separate account for these disability contributions.

The Act does not permit disability contributions on behalf of disabled employees who were officers, owners, or highly compensated.

Effective Date

The provision applies to years beginning after December 31, 1981.

7. Participation in group trusts by governmental plans (sec. 254 of the Act and sec. 401 of the Code)

Prior Law

Group trusts

Under prior law and present law, trusts that are parts of qualified pension, profit-sharing or stock bonus plans or individual retirement accounts (IRAs) may pool their assets in a group trust, usually created for the purpose of diversifying investments. If certain requirements are met, the pooling of assets does not affect the tax-exempt status of the contributing trusts, and the group trust itself is exempt from tax (Rev. Rul. 81-100, 1981-1 C.B. 326).

Governmental plans

A funded pension plan, including a governmental plan,[1] is a qualified plan if it meets certain requirements of the Internal Revenue Code. Also, a trust forming a part of a qualified pension plan is exempt from tax as a qualified trust if (1) employer contributions to the trust are made for the purpose of distributing the corpus and income to employees and their beneficiaries, and (2) under the trust instruments it is impossible for any part of the trust corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of employees before the liabilities to employees and their beneficiaries are satisfied. In addition to other tax-qualification requirements, the plan must not discriminate in coverage or in contributions or benefits in favor of employees who are shareholders, officers or highly compensated. Also, contributions or benefits must not exceed specified limits.

The Internal Revenue Service announced that issues concerning prohibited discrimination in coverage or in contributions or benefits under State and local governmental plans will not be raised by the Service until a review of the antidiscrimination rules is completed.[2] The Service announced that it is reconsidering the application of the antidiscrimination rules to plans covering elected and appointed officials of State and local governments. Pending completion of its review, the Service will resolve any issue under the rules in favor of a governmental plan's retaining its tax-qualified status.

A trust forming a part of a government plan is not exempt from tax if the trust engages in specific prohibited transactions described by the Code.

---

[1] A governmental plan is a plan established and maintained for its employees by the Government of the United States, by any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing.

[2] I.R.S. News Release IR-1869, August 10, 1977.

Reasons for Change

Congress understands that trustees of group trusts often are reluctant to allow governmental plans to participate in the trusts on account of uncertainty as to the qualified status of such plans. Congress believed it appropriate to remove this barrier to participation in group trusts by governmental plans.

Explanation of Provision

Under the Act, the tax-exempt status of a group trust will not be adversely affected merely because the trust accepts monies from (a) a retirement plan of a State or local government, whether or not the plan is a qualified plan and whether or not the assets are held in trust, or (b) directly from a State or local government, if such are monies intended for use in satisfying an obligation of such State or local government to provide a retirement benefit under a governmental plan.

A group trust is subject to the fiduciary standards (including the rules relating to prohibited transactions) of the Employee Retirement Income Security Act of 1974 (ERISA) if a participating trust is subject to the standards. Such a group trust will remain subject to the standards, even though the trust includes a governmental plan. In addition, any group trust in which a plan of a private employer participates will remain subject to the present-law rules relating to unrelated business taxable income (sec. 511 et seq.), notwithstanding that the trust includes a governmental plan.

Effective Date

The provision is effective for taxable years beginning after December 31, 1981.

8. Revenue effect of pension provisions

The pension provisions of the Act are expected to increase fiscal year budget receipts by $194 million in 1983, $780 million in 1984, $870 million in 1985, $970 million in 1986 and $1,058 million in 1987.

E. Taxation of Life Insurance Companies and Annuities

1. Repeal of modified coinsurance provisions (secs. 255, 256, 257, and 258 of the bill and secs. 805, 809, 811, 818 and 820 of the Code)*

Prior Law

A life insurance company sometimes will insure itself against some policy risks it has undertaken. This type of insurance between insurance companies is referred to as "reinsurance". Modified coinsurance, commonly referred to as "Modco," is a type of reinsurance agreement under which the company transferring some of its risks (the "ceding" company) retains ownership of the assets connected with the risks reinsured and also retains the reserve liabilities connected with the risks reinsured. In consideration, the company which has agreed to assume the risks under the agreement (the "reinsurer") receives both premium income and investment income attributable to the policies reinsured from the ceding company. Thereafter, periodic settlements are made between the companies for premiums collected, benefits paid, etc.

Prior law (Code sec. 820) contained a rule which allowed the ceding company and the reinsurer to report a modified coinsurance transaction for tax purposes as if the assets relating to the risks reinsured were transferred to the reinsurer, as if the premium income for the reinsured policies and the investment income on the assets were received directly by the reinsurer, and also as if reserves to reflect liability for future claims were maintained by the reinsurer. However, no transfer of assets actually occurred.

Reasons for Change

The prior law provision (Code sec. 820) was originally intended to avoid possible double taxation to both the ceding company and the reinsurer when a modified coinsurance agreement was used. However, some life insurance companies had used modified coinsurance to avoid or substantially reduce income tax paid by both the reinsurer and the ceding company. For example, since under prior law a life insurance company could not deduct policyholder dividends in excess of underwriting income (plus $250,000), it benefited by converting investment income into underwriting income which then could be offset by excess policyholder dividends which would not otherwise be deductible. Similarly, a company with gain from operations exceeding its investment income, but without sufficient dividends to offset all underwriting income, benefited by converting investment income into underwriting income because the tax on half of the underwriting income is deferred.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, secs. 256, 257, 258, and 259; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 333-337; Senate floor amendments, 128 Cong. Rec. S. 9018 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 641-642 (Joint Explanatory Statement of the Committee of Conference).

Any increased income to the reinsurer because of the deemed transfer of investment income was offset by an "experience refund" to the ceding company equal to the investment income minus a minor "service charge." Moreover, a reinsurer may have received an additional benefit of sheltering its other income if it had elected the approximate method for revaluing reserves computed on a preliminary term basis.

Thus, the effect of entering into a modified coinsurance agreement with a section 820 election was often to convert taxable investment income into underwriting income on which a lesser or no tax was paid by the ceding company and to reduce gain from operations for the reinsurer.

Explanation of Provisions

Modified coinsurance rules

The Act repeals the modified coinsurance rules under prior law (Code sec. 820). The repeal applies, as of January 1, 1982, for purposes of computing the life insurance company's taxable income, i.e., for purposes of determining taxable investment income and gain from operations. Subject to special termination accounting rules, the repeal applies to the treatment of modified coinsurance contracts entered into prior to 1982 for taxable years beginning after December 31, 1981.[1]

Conforming change for policyholder dividends reimbursements

The modified coinsurance rules under prior law (Code sec. 820(c)(5)) provided that the dividends paid in respect of a reinsured policy were treated as paid by the reinsurer and not the reinsured (to the extent the reinsurer reimbursed the reinsured). This rule also applied in respect of an insurance or annuity policy reinsured under a conventional coinsurance contract as well as a modified coinsurance contract.

As a conforming change with the repeal of the modified coinsurance provisions, the Act prescribes new rules for the tax treatment of reimbursements of policyholder dividends under a reinsurance arrangement.[2] In general, the policyholder dividends paid in connection with reinsured policies are treated as paid by the reinsured company rather than the reinsurer. Thus, a reinsured company will not be permitted to avoid the limitation on deductible policyholder dividends applicable to it by shifting the policyholder dividends deduction to a reinsurer which is eligible for larger deductions.

---

[1] For taxable years beginning before 1982, the provisions of prior law will apply with respect to those taxable years even if the consent of the reinsured and reinsurer required under prior law is submitted with income tax returns that are timely filed after 1981.

[2] The amendment providing for the inclusion of policyholder dividend reimbursements in income for a ceding company (Code sec. 809(c)(1)(F)) applies generally to all reinsured policies. However, the accounting method provisions (Code sec. 811(c)), relating to the corresponding deductions for the reinsurer, refers only to conventional coinsurance contracts. It is anticipated that this latter provision will be considered in connection with technical corrections of the Act, i.e., consideration of an amendment to conform the scope of the deduction provision for a reinsurer to the income inclusion rule for a ceding company.

Under the provision, the reinsured will include the amount of reimbursements received or accrued for policyholder dividends from a reinsurer in determining the gross amount of premium income (Code sec. 809(c)(1)). The policyholder dividends would then be deductible by the reinsured subject to the limitation applicable to it (Code secs. 809(d)(3) and (f)). Correspondingly, to avoid a double disallowance of any portion of the policyholder dividends, the full amount of the reimbursements will be deductible by the reinsurer (Code sec. 809(d)(12) and 811(c)). For this purpose, an accrual method will be used to determine the amount of deductible policyholder dividend reimbursements for a reinsurer. Thus, the provision will be consistent with the general rules relating to deductible policyholder dividends (Code sec. 811(b)) rather than a cash method which had been prescribed for reimbursements under the provisions of prior law under a Court of Claims decision.[3]

Special termination accounting rules

The Act prescribes special accounting rules for unwinding the tax treatment of modified coinsurance contracts in effect on December 31, 1981, to which the modified coinsurance rules of present law apply. Generally, those contracts are to be treated as terminated on January 1, 1982, for most purposes under the provisions of the bill.

As of the beginning of the first taxable year beginning after 1981, the reserves and the assets in relation to the reserves are to be treated as reserves and assets of the reinsurer (assuming company) and not of the reinsured (ceding company). At the end of that year, the assets and reserves will be treated as having been returned to the ceding company. By treating the assets and reserves as having been returned during the taxable year, the related tax consequences with respect to the deemed termination[4] will be treated in a manner consistent with the original transaction which occurred after the beginning of a taxable year and thereby did not affect opening asset and reserve amounts for the taxable year.

Beginning with the first taxable year after 1981, all of the gross investment income derived from the assets is to be treated as the gross investment income of the ceding company. No portion of gross investment income earned after 1981 is to be treated as the income of the assuming company. Similarly, all premiums collected after 1981 are to be included in premium income of the ceding company and not that of the asssuming company. Finally, expenses and policyholder dividend deductions attributable to the reinsured policies will be deductible only by the ceding company after 1981.

In general, the assuming company will be allowed a deduction in determining gain or loss from operations for an amount equal to the "termination amount" (generally reflecting the assets considered returned to the ceding company) and will reflect an increase in income in determining gain from operations attributable to the decrease in reserves with respect to the policies reinsured (sec. 810).

---

[3] *Lincoln National Life Ins. Co.* v. *U.S.*, 582 F. 2d 579 (1978).

[4] Thus, the computations of the mean of the assets and reserves taken into account for purposes of allocating the excludable portion of investment yield to policyholders under sections 804(a) and 805 will not include these assets and reserves in the opening or beginning assets and reserves of the ceding company.

The deduction for the termination amount will be allowed only as an other trade or business deduction (sec. 809(d)(11)) and cannot be taken into account for purposes of any other deduction (including treatment as an offset to premium income under sec. 809(c)(1)). For purposes of the Act, the "termination amount" means the amount that the assuming company would have returned to the ceding company upon termination of the contract if it had been terminated as of January 1, 1982. In general, this amount will reflect the basis or value of the assets relating to the reinsured policies. The provision is not intended to disallow deductions for other actual payments made by the reinsurer in connection with the contract, e.g., reimbursements for claims, etc.

In cases where an assuming company recognizes income for reserve decreases in excess of the deduction for the termination amount, special rules are provided to permit payment of the tax attributable to the excess in 3 annual installments. Under this provision, an assuming company may elect to pay the additional tax in three equal annual installments beginning March 15, 1983, the due date for the corporate return for calendar year 1982. However, for the installment due on March 15, 1983, the taxpayer can defer paying one-half of that installment until June 15, 1983. No interest will be charged on the deferred payments. For purposes of the provision, the amount eligible for deferred payment will be equal to the amount by which (1) the net income tax liability for the first taxable year beginning in 1982 (after credits other than for estimated taxes) which is determined by taking the amounts allocable to the modified coinsurance contract termination treatment into account exceeds (2) the net income tax liability determined without regard to the amounts allocable to the termination treatment. Special rules are also provided with respect to acceleration of unpaid installments if a payment is not made when due, proration of deficiencies to installments, posting of any bond required by the Secretary of the Treasury, and tolling of the period of limitations for making assessments with respect to the collection of tax attributable to the contracts treated as terminated.

The ceding company will include an amount equal to the termination amount in its gross income for its first taxable year beginning after 1981 (as other income under Code sec. 809(c)(3)) and, subject to a special limitation, take the increase in reserves for the contracts into account in computing gain or loss from operations (Code sec. 810). Under a special limitation designed to limit revenue losses, the increase in reserves taken into account for 1982 will be limited to the termination amount included in income. The beginning reserves for the next taxable year will reflect the full amount of the reserves without any reduction attributable to the special limitation.

The special limitation will not apply to any portion of any policies with respect to which a taxpayer is both the reinsured and reinsurer under modified coinsurance contracts, i.e., when a reinsurer has retroceded the policies to another reinsurer. In this case, the deduction for increases in reserves resulting from termination accounting for the retrocession will be fully allowed to offset the income for decreases in reserves resulting from termination accounting for the original modified coinsurance transaction.

The increase in reserves generally taken into account by the ceding company under the termination accounting rules for purposes of computing gain or loss from operations will not be taken into account, in the case of nonparticipating policies, for purposes of the special deduction for 10 percent of the increases in reserves for such policies (Code sec. 809(d)(5)).

A special election is provided under which certain ceding companies may revoke a section 820 election for modified coinsurance contracts entered into during 1980 or 1981 with an unrelated reinsurer. Only a company that had a loss from operations or was a "phase II negative" company for the year of the transaction is eligible to revoke the section 820 election. If revoked, the contract is treated as a modified coinsurance contract to which a section 820 election did not apply with respect to the reinsured company for all taxable years for which the contract is in force. This special election must be made within six months after the date of enactment of the Act.

Denial of interest deduction on indebtedness incurred in connection with reinsurance agreements

To discourage the use of reinsurance agreements for tax avoidance purposes similar to those involved with modified coinsurance, the Act denies interest deductions otherwise taken into account in allocating investment income to policyholders (Code sec. 805) if the interest is incurred after December 31, 1981, by a ceding company, or its affiliates, in connection with a reinsurance contract. This provision will not apply to interest paid on account of delay in making periodic settlements of income and expense items under the terms of the contract.

A special transition rule is also provided to except interest paid in connection with a corporate restructuring transaction from the limitation imposed on interest incurred on debt issued for a coinsurance arrangement entered into early in 1982. The exception applies only if substantial cash principal payments were made prior to July 1, 1982, and the note is fully paid in cash before January 1, 1983.[5]

Congress intended that no inference is to be drawn from the inclusion of the limited specific rules for debt-financed reinsurance arrangements but not for other arrangements. In appropriate circumstances, the Internal Revenue Service may challenge other reinsurance contracts on other grounds, e.g., the lack of economic substance of a transaction, the lack of a bona fide business purpose, or that the agreement is not an insurance agreement.

Treasury allocation authority for related party coinsurance contracts

The Act also grants authority for the Internal Revenue Service to reallocate or recharacterize items related to a reinsurance contract between related persons if the Service determines that it is necessary to reflect the proper source and character of taxable income of the parties (including any item used in determining taxable investment income and gain from operations). The scope of authority granted under the provision is broader than that granted under existing law generally (Code sec. 482). This provision may be applied by the Service to reinsurance arrangements involving an affiliated casualty insurance company. This provision may also apply to a contract even if one of the related parties is not a domestic life insurance company.

---

[5] Under the special transition rule, an amount not less than 20 percent of the amounts reinsured must have been paid in cash on the effective date of the contract and at least 40 percent of the note principal must have been paid in cash by the ceding company as of July 1, 1982.

Modified coinsurance grandfather protection

For taxable years beginning before January 1, 1982, the Act provides that, except in the case of fraud, the determination of whether a contract satisfies the modified coinsurance definitional requirements under present law (Code sec. 820(b)) is to be made solely by reference to the terms of the contract. Also, the Act provides that the rules governing the tax treatment of items relating to a modified coinsurance contract for those taxable years (Code sec. 820(c)) are to be applied in accordance with the Treasury regulations in effect on December 31, 1981.

Effective Dates

The repeal of the modified coinsurance rules and the conforming change for the treatment of policyholder dividends by an assuming company for reinsurance apply to taxable years beginning after December 31, 1981.

The special termination accounting rules for modified coinsurance contracts apply to a taxpayer's first taxable year beginning after 1981.

The provision denying interest deductions with respect to certain coinsurance contracts applies to interest paid or accrued after 1981.

The provision granting special allocation authority to the Internal Revenue Service with respect to reinsurance between related parties applies to contracts entered into after the date of enactment of the Act.

2. Policyholder dividends (secs. 259 and 263 of the Act and sec. 809 (d)(3), (5) and (6) and (f) of the Code)*

Prior Law

In addition to ordinary business deductions, special deductions are allowed in computing a life insurance company's gain from operations. The combined deductions for policyholder dividends, for nonparticipating contracts, and for accident and health and group life insurance contracts are subject to special limitation. Under prior law these deductions could not exceed $250,000 plus the amount by which gain from operations (computed without regard to these deductions) exceeded taxable investment income.

Reasons for Change

Congress believed that the policyholder dividend deduction limitation should be revised to carry out Congressional intent that investment income attributable to insured pension plans would be tax-free and permit the insurance industry to compete effectively for qualified pension plan business.

Further, Congress believed that the level at which policyholder dividends are deductible should generally be increased for a period pending a complete review of this area of the tax law.

Finally, Congress believed that the minimum dollar limitation on deductible amounts should be increased during a two-year period to reflect the effects of inflation since the prior amount was enacted in 1959, and to restore the assistance originally intended for small companies. Congress also believed that the benefits of the minimum dollar limitation should be targeted toward small companies.

Explanation of Provisions

For a two-year period, there are two alternative means of calculating the limitation for the policyholder dividend deduction and other special deductions.

In general, the first alternative revises the prior limitation by increasing the statutory dollar limit from $250,000 to $1 million. This limitation applies unless, for any taxable year, the taxpayer elects to apply the second alternative limitation.

The second alternative generally provides a limitation determined as the sum of:

(a) 100 percent of the dividends attributable to insured qualified pension plans;

---

*For legislative background of the provision, see H.R. 4961, as reported by the Senate Finance Committee, secs. 261 and 265; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp 338-339; and H. Rep. No. 97-760 (August 17, 1982), pp. 642-643 (Joint Explanatory Statement of the Committee of Conference).

(b) a statutory amount of $1,000,000 (same as in the first alternative); and

(c) in the case of a mutual company, 77½ percent of the amount of policyholder dividends paid on other than qualified pension business or, in the case of a stock company, 85 percent of the sum of such policyholder dividends and the special deduction for nonparticipating contracts.

The Act revises the manner in which the statutory dollar amount applies to an affiliated group of corporations. In the case of an affiliated group, the dollar limit is to be divided equally among the companies which are component members of the group on December 31 of each taxable year unless Treasury regulations are prescribed to permit an unequal allocation.

The benefits from the statutory dollar amount are targeted toward smaller companies. The dollar limit is phased down when the sum of the policyholder dividends and the special deduction amounts (amounts attributable to nonparticipating contracts otherwise allowable under section 809(d)(5) and to accident and health and group life insurance contracts otherwise allowable under section 809(d)(6)) exceeds $4 million. The dollar limitation is totally eliminated when the sum of the policyholder dividends and special deductions equals or exceeds $8 million. At this "large company" level, neither limitation reflects a statutory dollar amount.

With respect to the percentage limitations of 77½ percent for mutual companies and 85 percent for stock companies, the 7½ percent differential was intended to reflect the fact that a portion of the dividend distribution to mutual company policyholders constitutes a return of corporate earnings to them (derived from their ownership interest in the company), and accordingly, should not be deductible.

The second alternative limitation is determined by applying the applicable percentage to a "base amount". For this purpose, the "base amount" is defined as the excess of the sum of the amounts otherwise deductible as policyholder dividends (Code sec. 809(d)(3)) and as the special deduction for nonparticipating contracts (Code sec. 809(d)(5)) [6] over the fully deductible dividends allocable to qualified pension plans.

Each limitation applies first to policyholder dividends, then to the special deduction for nonparticipating contracts, and finally to the special deduction for accident and health and group life insurance contracts.

Effective Date

The provisions are effective for a temporary two-year period and apply to taxable years beginning after December 31, 1981, and before January 1, 1984.

---

[6] Although the special 2 percent of premiums deduction for accident and health and group life insurance (Code sec. 809(d)(6)) is subject to the limitation, those amounts are not taken into account in computing the base amount. In effect, this treatment essentially preserves the nondeductible treatment for these amounts that has existed generally since 1959 and protects against substantial revenue losses which would otherwise occur.

3. Life insurance reserves (secs. 260, 263, and 267 of the Act and sec. 818 of the Code)*

Prior Law

The concept of reserves is taken into account for several purposes under the life insurance company tax rules. The concept of life insurance reserves is relevant to the definition of a life insurance company which is subject to the special tax provisions; the concept of adjusted life insurance reserves is taken into account for purposes of determining the policyholders' share of investment yield which is excludable from taxable investment income; and increases and decreases in life insurance and other reserves are taken into account in determining gain or loss from operations.

Preliminary term reserve revaluation

Prior law (Code sec. 818(c)(2)) permitted taxpayers to revalue life insurance reserves computed on a preliminary term basis to a net level premium basis. Reserves computed on the preliminary term basis generally would decrease a company's reserve liabilities and, accordingly, increase its surplus. Thus, for State regulatory purposes, a company using this method for computing reserves would be permitted to write a larger volume of business than if reserves were computed on a net level premium basis. The revaluation election was intended to permit a company to deduct reserves for Federal income tax purposes under the net level premium basis even if the company used the preliminary term method for computing reserves for State law purposes.

This revaluation was done under either an exact revaluation method or an approximate revaluation method. Under the approximate revaluation method, reserves were increased by $21 per $1,000 insurance in force (other than term insurance) less 2.1 percent of reserves under such contracts. Reserves for term insurance were increased by $5 per $1,000 term insurance in force covering a period of more than 15 years, less 0.5 percent of reserves under such contracts.

Reserves for guaranteed interest

Under prior law, certain taxpayers had calculated reserves for certain deferred annuities and similar contracts (including certain tax-qualified pension contracts) in a manner that accelerated deductions for interest (in excess of the rate assumed for State law purposes) guaranteed for periods subsequent to the taxable year. In general, the reserve was computed by assuming that the interest guaranteed for future periods would be paid at the guaranteed rate but discounting the amount so computed to present value at the end of the company's taxable year at the low rate assumed for State regulatory purposes (typically at a rate of approximately 4 percent). The effect of computing reserves in this manner was to accelerate deductions in computing gain from operations for interest payable in subsequent taxable years. This computation also increased the reserves for purposes of computing the portion of investment yield excludable from taxable investment income.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, secs. 262 and 265; S. Rep. No. 97-494. Vol. 1 (July 12, 1982), pp. 340-342; Senate floor amendments, 128 Cong. Rec. S8946 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 643-644 (Joint Explanatory Statement of the Committee of Conference).

Contract liability for group pension contracts

Under prior law, life insurance companies were deemed to allocate investment yield to pension contracts on the basis of the current earnings rate whether or not that rate exceeded the rate guaranteed under the contract. However, if the guaranteed rate of interest exceeded the current earnings rate, a taxpayer could allocate investment yield at the guaranteed rate rather than the current earnings rate by removing life contingencies from the contracts.

Life insurance company status

For purposes of qualifying as a life insurance company for tax purposes, present law requires that more than 50 percent of a company's total reserves must consist of life insurance reserves. The Internal Revenue Service has several pending ruling requests concerning the reserve treatment of funds held under certain pension contracts that do not contain permanent annuity purchase rate guarantees.

Reasons for Change

Congress believed that the approximate method for revaluing reserves for life insurance other than term insurance on a preliminary term basis ($21 per $1,000 insurance in force) should be revised because it produced reserves greater than what was actuarially needed. In recent years, the practical effect of using the approximate method for revaluing these reserves had been to accelerate the timing for reserve deductions faster than had been available when the formula was developed in 1959. This was due to changed circumstances since 1959 (e.g., mortality, product and reserve method changes). Moreover, the revenue cost increased because many large established companies had obtained excessive allowances by electing the method which was originally intended to aid new and small companies by providing an administratively simple method of recalculating reserves.

Congress also believed that it was appropriate to prevent companies from obtaining an accelerated deduction for interest in excess of the assumed rate that is guaranteed for periods after the close of a taxable year. Moreover, Congress believed that restrictions are required to preclude excessively generous treatment for annuity contracts and qualified pension contracts since the Act also permits a 100 percent deduction for interest credited on annuity contracts and for policyholder dividends credited to qualified pension contracts.

Congress also believed that it was appropriate to revise the rules applicable to group pension contracts to eliminate so-called "double-dip" benefits under prior law.

Finally, Congress believed that, for taxable years before 1984, the status of a company as a life insurance company should not be changed because of the treatment of group pension contracts without permanent purchase rate guarantees.

Explanation of Provisions

Preliminary term reserve revaluation

The Act reduces the amount by which reserves computed on a preliminary term basis may be increased for insurance other than term insurance under the approximate revaluation formula (Code sec. 818(c)(2)). For that insurance, reserves are increased by $19 per $1,000 insurance in force and reduced by 1.9 percent of the reserves (rather than by $21 per $1,000 insurance in force and reduced by 2.1 percent under prior law).

The Act permits taxpayers to switch from the approximate revaluation method to the exact revaluation method without obtaining the consent of the Internal Revenue Service. A taxpayer may adopt the exact revaluation method for its first taxable year beginning after 1981 but only with respect to reserves for contracts issued after March 31, 1982.

Congress was informed that some policies which are in substance renewable term policies eligible only for, at most, the $5 per thousand approximate revaluation adjustment have been labeled "whole life" policies so that the issuing company may claim the higher revaluation adjustment for insurance other than term insurance.[7] For example, in certain cases, these disguised term policies have not provided a cash surrender value until the contract has been in force for 16 years or longer, or have provided for the payment of premiums commensurate with a whole life insurance policy only when the insured is 80 years old. While certain graded premium policies may be appropriately treated as whole life policies, many graded premium policies are not entitled to the reserve deductions claimed by the issuing companies. It was understood that whole life policies eligible for the $19 per thousand reserve revaluation adjustment should either have a substantial cash surrender value within several years after the policy is issued, or level premiums should be charged within a relatively short period of time after the policy is issued. The Treasury Department is expected to issue regulations dealing with this matter.

Reserves for guaranteed interest

With respect to interest guaranteed under a contract, the Act provides that, in computing reserves with respect to the contract, the interest guaranteed for periods beyond the end of the taxable year is not to be taken into account to the extent attributable to an interest rate exceeding the rate assumed in computing statutory reserves.

---

[7] Report to the Congress by the Comptroller General. "Billions of Dollars Are Involved in Taxation of the Life Insurance Industry—Some Corrections in the Law Are Needed," p. 65 (Report No. PAD-81-1, Sept. 17, 1981).

The new reserve computation method is limited in scope to contracts which provide for the accumulation of interest that is payable to policyholders. For example, the new reserve computation method is applicable to so-called excess interest contracts where the interest is separately stated and guaranteed in excess of State law valuation rate beyond the end of the taxable year. The new method is not applicable, however, to policies which do not guarantee a separately identifiable excess interest component beyond the taxable year. For example, the provision does not apply to annuity contracts purchased by a qualified pension plan primarily to provide periodic retirement benefits due under the plan to participants.

A transitional rule is provided for the rules disallowing excess interest guaranteed beyond the close of a taxable year for certain situations when the establishment of such reserves for taxable years beginning before January 1, 1982, did not result in any Federal income tax benefits. That is, the transitional rule applies if the taxpayer did not benefit from a deduction for an increase in reserves or from having a higher level of reserves for purposes of computing taxable investment income. In these cases, the amount of such reserves may be recomputed by a taxpayer as of the beginning of the first taxable year beginning after December 31, 1981, to reflect the amount that would have been determined as of the close of the previous taxable year if the new limitation had been in effect. This recomputation would be taken into account for purposes of determining any increase or decrease in reserves for taxable years beginning after December 31, 1981, However, taxpayers taking advantage of this transition rule must compute such reserves in accordance with the new rule notwithstanding the fact that the interest rate guarantees were made prior to July 1, 1982.

Contract liability for group pension contracts

The Act provides that, beginning January 1, 1983, the policy or other contract liability requirements for group pension contracts, for purposes of determining the excludable policyholder share of investment yield, is limited to the amount actually credited to the contracts (whether credited through premium rate computations, reserve increases, excess interest, experience rate credits, policy holder dividends, or otherwise). In general, this limitation applies on the basis of the total business for these contracts rather than on a policyholder by policyholder basis. The intention was to eliminate the so-called "double-dip" available under prior law with respect to these contracts.

Life insurance company status

The Act provides that, for any taxable year ending before January 1, 1984, life insurance company status for a company will not be changed because of the effect of reserves for group pension contracts without permanent annuity purchase rate guarantees.

Effective Dates

The provision relating to the approximate revaluation formula is effective for contracts entered into after March 31, 1982, for taxable years beginning after December 31, 1981.

The provision relating to the computation of reserves for guaranteed interest applies to guarantees made after July 1, 1982, and before January 1, 1984, for taxable years beginning after December 31, 1981, and before January 1, 1984.

The provision relating to the determination of the policy or contract liability for group pension contracts applies to taxable years beginning after December 31, 1982, and before January 1, 1984.

The provision dealing with the status of a company as a life insurance company applies to taxable years ending before January 1, 1984.

4. Menge formula (secs. 261 and 263 of the Act and sec. 805(c) of the Code)*

Prior Law

Under prior law, a formula, commonly called the "Menge" formula, was used to compute the amount of adjusted life insurance reserves. Simply stated, the "Menge" formula was a mechanical arithmetic adjustment used to compute adjusted life insurance reserves. This computation was then used in determining the policyholders' share of investment yield and accordingly affected the computation of a life insurance company's taxable investment income.

The formula operated to reduce life insurance reserves (other than pension reserves) by 10 percent for each percentage point by which the adjusted reserves rate (the lower of the average earnings rate for a 5-year period or the current earnings rate) exceeds the interest rate assumed in calculating the reserves.

Reasons for Change

Congress believed that, for the two-year period for temporary corrections in the law, the inaccuracies in the operation of the "Menge" formula which are attributable to substantial increases in interest rates should be corrected.

Explanation of Provision

For a two-year period, the 10-for-1 "Menge" formula will be revised to allow the policyholders' share of investment yield to be computed by using a geometric 10-for-1 formula to adjust statutory life reserves.

Effective Date

The provision applies to taxable years beginning after December 31, 1981, and before January 1, 1984.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, secs 263 and 265; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), p. 343; and H. Rep. No. 97-760 (August 17, 1982), pp. 644-645 (Joint Explanatory Statement of the Committee of Conference).

5. Consolidated returns (secs. 262 and 263 of the Act and sec. 818 of the Code)*

Prior Law

Under prior and present law, two or more affiliated domestic life insurance companies may elect to file a consolidated return. Also, beginning in 1981, life insurance companies may be included in consolidated returns with non-life affiliated companies. For reporting purposes, some taxpayers have taken the position that taxable income first is determined for each component member of the affiliated group (e.g., taxable investment income for some companies and gain from operations for others) and then consolidated by adding those separate company taxable income bases. This approach is sometimes referred to as the "bottom line" method of consolidation.

The ruling position of the Internal Revenue Service, as indicated in letter rulings, has been that the taxable investment income bases and the gain from operations bases first must be aggregated to arrive at consolidated group amounts and then these aggregate tax bases (taxable investment income and gain from operations) would apply for the consolidated group. This approach is sometimes referred to as a "phase-by-phase" method of consolidation.

Under regulations proposed on June 3, 1982 with respect to consolidation of non-life and life companies, a modified phase-by-phase method of consolidation would apply to a life insurance subgroup of companies. Consolidated amounts would be determined by aggregating separate amounts for each member in a life subgroup and a consolidated limitation would apply whenever a deduction is limited by an amount or percentage of an amount (including the 50-percent deferral for gain from operations in excess of taxable investment income and the limitation on policyholder dividends and special deductions). The proposed regulations would apply to the first taxable year for which the due date (without extensions) for filing a return is after the date final regulations are adopted. The proposed regulations would apply only in the limited context of consolidation of life insurance companies and non-life affiliates, but indicate a preference of the Internal Revenue Service for "phase-by-phase" consolidation over "bottom line" consolidation of life insurance companies.

Reasons for Change

Congress believed that "bottom line" consolidated reporting should be permitted during the two-year period during which time a thorough Congressional review of this complicated area of the tax law can be conducted. In addition, Congress believed that prior reporting practices should be protected against any possible retroactive effect under revised Treasury regulations.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, secs. 264 and 265; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 344-345; H. Rep. No. 97-760 (August 17, 1982), p. 645 (Joint Explanatory Statement of the Committee of Conference).

Explanation of Provision

For a 2-year period, the Act provides that consolidated life insurance company taxable income will be determined by first computing the separate life insurance company taxable income for each affiliated company and then combining those amounts. This provision applies to the consolidation of affiliated domestic life insurance companies and to a life insurance subgroup within an affiliated group. Also, grandfathering protection is provided for companies that have taken this reporting position for taxable years beginning before 1982. Under this provision, the Internal Revenue Service cannot disturb a bottomline reporting position taken in a consolidated return, including an amended return, filed before July 1, 1982 (or, with respect to a taxable year beginning in 1981, a return filed before September 16, 1982).

The provisions will not affect the treatment of items computed on a consolidated basis which are not unique to life insurance companies, e.g., items such as charitable deductions would be subject to the general consolidated return rules applicable to all taxpayers.

Effective Date

The provision applies to taxable years beginning after December 31, 1981, and before January 1, 1984. The grandfather protection applies to taxable years beginning before 1982.

6. Full deduction for amounts credited to annuity contracts (sec. 264 of the Act and secs. 805 and 809 of the Code) [*]

Prior Law

The share of each and every item of investment yield of a life insurance company that is set aside for policyholders is not included in computing taxable investment income or the gain or loss from operations (secs. 805(a) and 809(a)). For purposes of computing gain or loss from operations, the share of any item set aside for policyholders is the percentage obtained by dividing the "required interest" by the investment yield. The required interest is the sum of the amounts determined by multiplying the required or assumed rates of interest used by the company in calculating reserves for State insurance law purposes by the mean of the applicable reserve at the beginning and end of the taxable year.[8] No interest in excess of the assumed rate of interest may enter into this calculation.

For purposes of determining gain or loss from operations, a deduction is allowed for all claims and benefits accrued, and all losses incurred during the taxable year on insurance and annuity contracts. Likewise, a special deduction is allowed for policyholder dividends (sec. 809(d)(3)). Under prior law, however, this deduction was limited to $250,000 plus the excess of gain from operations (computed without regard to special deductions) over taxable investment income.

In certain deferred annuity contracts, life insurance companies credit interest at rates in excess of the relatively low rate that is assumed in their contracts for State law purposes. This "excess interest" is typically credited at a rate that is guaranteed, in advance, for a temporary future period. In computing their taxable income, under prior law, these companies fully deducted the credited excess interest as additions to reserves to provide for benefits guaranteed under the contract.

The Internal Revenue Service took the position (Rev. Rul. 82-133) that the excess interest credited with respect to certain deferred annuity contracts was a policyholder dividend subject to the statutory deduction limitation.

---

[*] For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 266; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 346-348; Senate floor amendments, 128 Cong. Rec. S8946-S8947 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), p. 646 (Joint Explanatory Statement of the Committee of Conference).

[8] Six kinds of reserves are taken into account in computing required interest: (1) life insurance reserves; (2) unearned premiums and unpaid losses (not included in life insurance reserves); (3) amounts necessary to satisfy the obligations under insurance and annuity contracts, but only if such obligations do not involve (when the computation is made) life, health or accident contingencies; (4) dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts; (5) premiums received in advance and liabilities for premium deposit funds; and (6) special contingency reserves under contracts of group term life insurance or group health and accident insurance.

Reasons for Change

Congress believed that, in light of the changes that were made by the Act to the tax treatment of deferred annuity policyholders, a larger deduction should be allowed to the issuing company for amounts credited to these contracts.

In addition, although the legal issue concerning excess interest was unsettled, Congress was concerned that the practical effect of the Service's position would be to eliminate or substantially curtail the marketing of these products, resulting in a cessation or significant reduction of business on the part of some companies. Consequently, Congress resolved the legal uncertainty in this area with legislation.

Explanation of Provision

For purposes of computing taxable investment income, the Act provides that amounts of qualified guaranteed interest paid or credited with respect to certain annuity contracts be taken into account as interest paid for purposes of determining policy and other contract liabilities (sec. 805(a) (3) and (e)). This results in treating the portion of the investment yield allocable to those amounts as excludable from taxable investment income (sec. 804(a)(1)). Also, for purposes of determining gain or loss from operations, a similar treatment is prescribed by treating amounts of qualified guaranteed interest as required interest (sec. 809(a)(2)).

Qualified guaranteed interest

The term "qualified guaranteed interest" includes all amounts in the nature of interest determined (1) under a rate guaranteed in advance for not less than 12 months, or (2) under any formula or other method (including an "index") guaranteed in advance for not less than 12 months, if the terms of the formula are beyond the control of the company and are independent of the experience of the company. Although the actual rate under a formula or index may vary over a period of less than 12 months, the formula or index guarantee itself must meet the 12-month requirement.

The 12-month requirement will be met, under either guarantee alternative, if there is an advance contractual guarantee to each policyholder that any money received under the contract during a specified period of 12 months or longer will accumulate income at the guaranteed rate. Also, the 12-month requirement will be met if there is an advance contractual guarantee that any money received during a given week or month, or a particular sum of money, will accumulate income at a rate or under a formula that is guaranteed for a specified period of 12 months or longer. Thus, a contract may guarantee a 12 percent rate for one year for money in the contract as of January 1, and guarantee a 14 percent rate for money invested in July, provided the new rate for the new money also is guaranteed for at least 12 months. However, any new rate guaranteed on additional investments in the contract will not affect the amount of qualified guaranteed interest allowable for previous investments. For example, even if the new higher rate is applied to existing moneys in the contract, the amount of qualified guaranteed interest allowable would be computed based on the previous and lower guaranteed rate; the difference between the lower guaranteed rate and the higher rate credited would be excess interest not subject to this new provision.

To be a contractual guarantee, the rate or formula need not be actually stated in the individual contract so long as the company issuing the contract has made a commitment to pay a rate of interest that is legally binding under State law and is enforceable by the policyholder with respect to the contract. Also, where the interest guarantee is made upon issuance of a contract, the initial guarantee need only be until the end of the company's taxable year in which the contract was issued.

Under a special effective date, existing contracts failing to qualify because the guarantee is for less than 12 months are grandfathered with respect to moneys held on August 13, 1982, and any qualified guaranteed interest on such moneys after such date. For contracts issued after August 13, 1982, and before January 1, 1983, which may have guarantees for less than 12 months, such contracts will be treated as meeting the 12-month guarantee requirements retroactively if they meet such requirements on the first contract anniversary date. Although it is not specifically addressed by the statutory language, it would be consistent with the two special effective dates to treat an existing multiple premium annuity contract (a contract issued before August 14, 1982, under which additional premiums are received after August 13, 1982) as meeting the 12-month guarantee requirements if it is so conformed by August 13, 1983.

Qualified contracts

Qualified guaranteed interest will only be allowed for annuity contracts which involve (at the time the interest is credited) life contingencies, which are nonparticipating under State law and which provide for the crediting of excess interest. Participating contracts, meeting all other requirements, also qualify as contracts paying qualified guaranteed interest, but the interest deduction is limited to 100 percent of the guaranteed rate of interest assumed in calculating reserves and 92½ percent of any interest credited in excess of that assumed rate. The statute specifically disallows any deduction or exclusion from income for the remaining 7½ percent of the excess interest on participating contracts, both in computing taxable investment income and in computing gain or loss from operations. An existing annuity contract that does not provide specifically for the payment of excess interest can be conformed to meet this requirement, without individual contract amendments, as long as the action taken by the company to so conform the contracts is in accordance with State law and is enforceable by the policyholder with respect to the contract.

Contracts used to fund qualified pension plans (described in section 805(d)) are excluded from the qualified guaranteed interest provisions since policyholder dividends under such contracts are fully deductible under the Act's new dividend limitation formula, in addition to such contracts being subject to the special investment yield allocation rules based on current earnings rates (sec. 805(a)(2)). Also, the provisions do not apply to variable annuity contracts with reserves based on segregated asset accounts (sec. 801(g)).

Conforming changes for computation of income

Since, for purposes of computing taxable investment income, the qualified guaranteed interest will be taken into account separately for allocating the excludable policyholders' share of investment yield, the Act excludes the contractual policy interest and related reserves from other computations relating to this allocation (i.e., the determination of adjusted life insurance reserves (sec. 805(c)) and the operation of the Menge formula). Thus, in computing taxable investment income, no double exclusion is allowed with respect to the assumed rate portion of the qualified guaranteed interest (i.e., no amount will be excluded as being attributable to the interest assumed under section 805(a)(1), to the extent it is taken into account as interest paid under section 805(a)(3)).

Finally, the Act provides that qualified guaranteed interest is included in "required interest" (sec. 809(a)(2)) for purposes of computing gain or loss from operations. Again, to avoid a double exclusion for the assumed interest portion of the qualified guaranteed interest, reserves on these contracts are excluded from the reserves that are multiplied by their assumed rates to produce a portion of the required interest. Since qualified guaranteed interest is already taken into account in required interest, no part of such interest can be included in computing either the deduction for an increase in reserves (sec. 809(d)(2)), or the income item from a decrease in reserves (sec. 809(c)(2)), or as an interest paid deduction (sec. 809(d)(11)).

As described above the qualified guaranteed interest provisions apply only to annuity contracts. However, the Act also provides special grandfather relief for excess interest contracts that are not annuities (e.g. universal life insurance contracts). Specifically, section 263(b) of the Act provides that for taxable years beginning before January 1, 1982, if a company on its return for that year treated amounts described as "excess interest" as not being a policyholder dividend, then such amounts are so treated for tax purposes. The issue of whether such amounts are properly treated as "interest" or policyholder dividends is left open for taxable years after January 1, 1982.

Effective Date

Generally, these provisions apply for taxable years beginning after December 31, 1981. However, for contracts with interest guarantees for less than 12 months, (1) such contracts are grandfathered with respect to moneys held on August 13, 1982 (and any interest earned thereafter), and (2) contracts issued after August 13, 1982, and before January 1, 1983, will be treated as providing guarantees of not less than 12 months if they do so on the first contract anniversary date.

7. Tax treatment of deferred annuities (sec. 265 of the Act and sec. 72 of the Code)[*]

Prior Law

An annuity contract issued by a life insurance company is a promise to pay to the beneficiary a given sum for a specified period, which period may terminate at death.[9] Annuity contracts permit the systematic liquidation of an amount consisting of principal (the policyholder's investment in the contract) and income. The insurance company takes the risk that such amount will be exhausted before the company's liability under the contract ends, but gains if the liability terminates before that amount is exhausted.

The starting date for annuity payments may be within one year after the initial premium is paid (an immediate annuity) or may be deferred to a later date (a deferred annuity). The period between the time the first premium is paid for an annuity and the time the first annuity payment is due is referred to as the "accumulation period."

An individual may purchase an annuity by payment of a single premium or by making multiple premium payments. A deferred annuity contract may, at the election of the individual, be surrendered before annuity payments begin in exchange for the cash value of the contract. Partial surrenders are similarly permitted under some annuity contracts.

The taxation of interest or other current earnings on a policyholder's investment in an annuity contract generally is deferred until annuity payments are received or amounts characterized as income are withdrawn (secs. 72(a) and (e)). A portion of each amount paid to a policyholder as an annuity generally is taxed as ordinary income under an "exclusion ratio" (sec. 72(b)) computed to reflect the projected nontaxable return of investment in the contract and the taxable growth on the investment. Policy dividends paid after annuity payments begin are not subject to the "exclusion ratio," but are taxable in full to the policyholder as ordinary income. Under prior law, amounts paid out under a contract before the annuity payments began, such as payments upon partial surrender of a contract, were first treated as a return of the policyholder's capital and were taxable (as ordinary income) only after all of the policyholder's investment in the contract had been recovered.

---

[*] For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 267; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 349-351; Senate floor amendments, 128 Cong. Rec. S8946-S8947 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 646-647 (Joint Explanatory Statement of the Committee of Conference).

[9] If either the premium paid for an annuity contract or the annuity benefit under the contract is based on the investment return and the market value of a separate account established by the insurance company, the contract is called a "variable annuity contract."

Reasons for Change

Traditionally, annuity contracts have been safe, conservative, but low-yielding investments purchased by individuals who wish both to provide for income during their retirement and to insure against the possibility of outliving their assets. Deferred annuities typically guaranteed and limited both the rate of interest at which the principal would grow during the accumulation period and the rate at which that amount could be converted to annuity payments at the end of that period. Although taxes were deferred during the accumulation period, the relatively low yields and high commissions made deferred annuities less attractive for short-term investment by comparison with other investment alternatives.

In recent years, however, the life insurance industry has developed new products that provide an investment yield for the policyholder that is competitive with other commercial investments that do not enjoy the same tax treatment. By emphasizing the benefits of tax deferral during the accumulation period, the tax-favored treatment of partial surrenders, and options for lump-sum settlements, deferred annuities have been actively marketed as "tax shelters." Although the current tax rules were enacted when deferred annuities were used to provide long-term income security, variations on traditional products have been developed that are comparable to short-term money market investments.

Congress believed that the use of deferred annuity contracts to meet long-term investment and retirement goals, such as income security, was still a worthy ideal. However, Congress believed that their use for short-term investment and income tax deferral should be discouraged.

Explanation of Provision

Cash withdrawals

The Act makes two changes to the tax treatment of annuity contacts. The first change made by the Act is that partial surrenders or cash withdrawals prior to the annuity starting date are income to the extent that the cash value of the contract (determined immediately before the amount is received and without regard to any surrender charge) exceeds the investment in the contract. To the extent that such cash value does not exceed the investment in the contract, such withdrawals are a return of capital to the policyholder and reduce the taxpayer's investment in the contract.

Policyholder dividends received prior to the annuity starting date are cash withdrawals subject to the new rules. Such policyholder dividends are not included in the taxpayer's income to the extent they are retained by the insurer as premiums or other consideration paid for the contract. However, the retained policyholder dividends do not increase the taxpayer's investment in the contract since such amounts received under the contract are excludable from gross income. Likewise, for purposes of this new rule, loans against a contract or pledging an annuity contract are treated the same as a cash withdrawal. Thus, a loan or pledge for a specific amount will be treated as a cash withdrawal of that amount when the loan or pledge is made. If the taxpayer pledges the entire contract, he will be treated as having received a cash withdrawal at the time of the initial pledge; moreover, whenever the contract is credited with additional income, which becomes subject to the pledge, then such additional income will be treated as additional cash withdrawals and taxed accordingly.

The following example illustrates the new cash withdrawal rules:

Example.—Assume that a taxpayer purchases a deferred annuity contract on January 1, 1983 for $10,000. Under the terms of the contract, there is a 3 percent surrender charge on surrenders within the first ten years of the contract; assume that income on the contract will accumulate at 10 percent. On January 1, 1984, the cash value of the contract (without surrender charges) is $11,000 and the taxpayer pays an additional premium of $5,000. On January 1, 1985, the cash value of the contract is $17,600 and the taxpayer makes a partial surrender requesting the company to send him $2,000. The taxpayer will be taxed on $2,000 of ordinary income, based on the following computation:

Cash value (without surrender charge) immediately before surrender	$17,600
Less investment in contract	15,000
Income available for withdrawal	2,600

The cash value of the contract after the withdrawal will be:

Cash value (without surrender charge) immediately before surrender	$17,600
Less amount of surrender	2,000
Subtotal	15,600
Less 3 percent surrender charge	60
Cash value after surrender	15,540

On January 1, 1986, the cash value of the contract is $17,094 and the taxpayer makes a partial surrender and receives $7,000. The taxpayer will be taxed on $2,094 of ordinary income ($4,906 will be a return of capital), based on the following computation:

Cash value (without surrender charge) immediately before surrender	$17,094
Less investment in contract	15,000
Income available for withdrawal	2,094

The cash value of the contract after the withdrawal will be:

Cash value (without surrender charge) immediately before surrender	$17,094
Less Amount of surrender	7,000
Subtotal	10,094
Less 3 percent surrender charge	210
Cash value after surrender	9,884

On January 1, 1987, the cash value of the contract is $10,872.40 and the taxpayer surrenders the contract in full, receiving $10,546.23, with the following tax result:

Amount received upon full surrender	$10,546.23
Less investment in contract	10,094.00
Income withdrawn	452.23

Of the amount received by the taxpayer, $452.23 is ordinary income and $10,094 is a return of capital.[10]

Retention of prior law for cash withdrawals in certain cases

The Act retains the prior law rules on cash withdrawals for any amount received under a qualified pension plan. Although not specifically excluded in the statute, amounts received under eligible State deferred compenstation plans (described in sec. 457) also would not be subject to the new cash withdrawal rules as they are not generally subject to the provisions of Code sec. 72; likewise, tax-exempt employer deferred compensation plans of 501(c)(3) organizations would be taxed under prior law. The Act does not change the tax treatment of withdrawals from most life insurance and endowment contracts. However, the Secretary is authorized to issue regulatory guidelines as to when the amount at risk under these types of contracts is sufficiently minimal that the contract should be treated as an annuity for purposes of these provisions. For example, if a contract is a flexible premium life insurance contract within the new guidelines for such (sec. 266 of the Act), that contract would not be subject to the new cash withdrawal provisions.

Finally, the new cash withdrawal rules do not apply to amounts invested in an annuity contract before August 14, 1982, nor to income accumulated on such amounts. To give full effect to this grandfather provision and to be consistent with a specific rule in the Act that attributes income withdrawn from a contract to the earliest investment first, cash withdrawals are considered to come, first, from investments prior to August 14, 1982, next from income accumulated with respect to such investments, then from income accumulated with respect to investments after August 13, 1982, and finally from investments after August 13, 1982. The following example illustrates the application of the new cash withdrawal provisions to a multiple premium annuity contract that was issued prior to August 14, 1982, and to which premium investments were added after August 13, 1982:

Example.—Assume that a taxpayer owns a flexible premium annuity contract that was issued prior to August 14, 1982, for which he paid $3,000; assume that the contract is no longer subject to cash surrender charges and that for 1983 and 1984, the contract will accumulate income at a rate of 10 percent. On January 1, 1983, the cash value of the contract is $5,500 and the taxpayer pays and additional premium of $2,000. On January 1, 1984, the cash value is $8,250 and the taxpayer requests a partial surrender of $6,500. The taxpayer is taxed on $3,250 of ordinary income, and $3,250 is a return of capital, based on the following computations:

Cash value immediately before surrender	$8,250
Less cash value of amounts invested before Aug. 14, 1982 ($5,500 plus $550 income for 1983)	6,050
Cash value of amounts subject to new provisions	2,200

---

[10] In the above example, the amount taxed as ordinary income would be subject to withholding under section 334 of the Act governing withholding on pensions, annuities, and certain other deferred income.

The taxpayer is considered to withdraw income attributable to his earliest investment first. Where the investment was made before August 14, 1982, prior law applies, allowing a return of capital before the withdrawal of income. Of the $6,050 cash value attributable to investment before August 14, 1982, the first $3,000 is a return of capital and the next $3,050 is income to the taxpayer. The remaining cash value, which is attributable to investments after August 13, 1982, is withdrawn under the new provisions, as follows:

Cash value immediately before surrender	$2,200
Less investment in contract	2,000
Income available for withdrawal	200

Of the remaining $450 of cash withdrawal that is not a withdrawal of grandfathered moneys, the first $200 is income and the remaining $250 is a return of capital. The cash value of the contract immediately after the surrender is $1,750.

Penalty on early withdrawals

The second change made by the Act is that a penalty is imposed on certain distributions from an annuity contract. The penalty is equal to 5 percent of the amount includible in income, to the extent the amount is allocable to an investment made within 10 years of the receipt of such amount. For this purpose, an amount includible in income is allocable to the earliest investment first. Also, because policyholder dividends received before the annuity starting date are cash withdrawals and includible in income to the extent there is income in the annuity contract available for distribution, such amounts are also subject to the 5 percent penalty to the extent the income in the contract is allocable to an investment within the last 10 years. Of course, if the policyholder dividend is retained by the company and reinvested in the contract, it is not includible in income and is not subject to the 5 percent penalty.

The penalty does not apply to a distribution that is (1) made on or after the policyholder reaches age 59½; (2) made to a beneficiary on or after death of the policyholder; (3) attributable to the policyholder becoming disabled; (4) one of a series of substantially equal periodic payments for life or at least 5 years; (5) from a qualified pension plan; or (6) allocable to an investment before August 14, 1982. The requirement that the amount be paid out as one of a series of "substantially equal" periodic payments is met whether it is paid as part of a fixed annuity, or as part of a variable annuity under which the number of units withdrawn to make each distribution is substantially the same. Finally, the penalty only applies to distributions made after December 31, 1982.

The second example given above can also be used to illustrate the application of the new penalty. Under the facts as stated, the taxpayer receives a cash surrender of $6,500, of which $3,250 is taxable as ordinary income. However, only $200 is income allocable to an investment after August 13, 1982. The taxpayer has to pay an additional penalty tax of $10 (5 percent of $200) because the withdrawal is made after December 31, 1982, and within 10 years of the January 1, 1983, investment.[11]

Although it is not specifically addressed in the statute, the insurance provisions of the Act do not alter the application of Code sec. 1035, which allows tax-free exchanges of annuity contracts. In order to give meaning to the effective dates, which grandfather under prior law investments and income held under annuity contracts as of August 13, 1982, a replacement contract obtained in a tax-free exchange of annuity contracts succeeds to the status of the surrendered contract for purposes of the new provisions. This means that money that was grandfathered under one contract continues to be grandfathered and subject to the prior law under the new contract. Likewise, the age of investments must be carried over from one contract to another for purposes of measuring the 10-year period under the new penalty tax. In order to further the proper reporting of annuity income, such exchanges are subject to the new provisions in this Act (sec. 334) for information reporting on pension plans and commercial annuity contracts.

Effective Date

The provisions apply to income amounts allocable to investments made to annuity contracts after August 13, 1982. However, the 5 percent penalty will apply only to amounts withdrawn after December 31, 1982.

---

[11] The penalty tax is not within the scope of the new provisions on withholding for pensions and anuities (sec. 334 of the Act).

8. Flexible premium life insurance contracts (sec. 266 of the Act and sec. 101 of the Code) *

Prior law

Gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if the amounts are paid by reason of the death of the insured (sec. 101(a)).

In addition, prior to the death of the insured, amounts credited to the cash value of a life insurance contract are taxed only when withdrawn and to the extent the withdrawals exceed the aggregate premiums paid by the policyholder for the contract (sec. 72(e)).

In recent years, life insurance companies have marketed flexible premium life insurance contracts (referred to as "universal life" or "adjustable life"). These contracts are similar in some respects to traditional whole life policies, but typically permit the policyholder to change the amount and timing of the premiums and the size of the death benefit automatically as the policyholder's needs change. These contracts may permit the policyholder to invest a substantial cash fund without a related increase in the amount of pure insurance protection offered by the contracts.

In a letter ruling (January 23, 1981), the Internal Revenue Service concluded that the entire amount paid upon the death of the insured under a universal life insurance contract is excluded from gross income as proceeds of a life insurance contract under section 101(a), even though the death benefit may reflect a large cash fund and a relatively small amount of pure insurance protection. If the contract is treated as a life insurance contract, the interest on the cash fund is not subject to tax, unless the contract is surrendered prior to the death of the insured. Subsequent to the letter ruling, the Service announced that it was reconsidering its position on such life insurance contracts. Thus, it was unclear whether such contracts will be treated as life insurance contracts for tax purposes.

Reasons for Change

Congress believed that flexible premium life insurance contracts should have the same tax treatment as traditional level-premium whole life insurance contracts if they are substantially comparable to traditional contracts. However, Congress was concerned by the fact that some flexible premium contracts can be overly investment oriented by allowing large cash value build-ups without requiring a continued reasonable amount of pure insurance protection. In the case of such contracts, the traditional use of life insurance as financial protection against early death could be overshadowed by the use of the contract as a vehicle for tax-favored investment.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 268; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 352-354; and H. Rep. No. 97-760 (August 17, 1982), pp. 647-649 (Joint Explanatory Statement of the Committee of Conference).

Because the uncertain tax treatment of flexible premium life insurance contracts has caused significant confusion among consumers and life insurance companies, Congress believed that it should resolve the tax treatment of these contracts, at least temporarily, by legislation.

Explanation of Provisions

The Act provides mandatory guidelines that flexible premium life insurance contracts must meet in order to be treated as life insurance for tax purposes. If these guidelines are violated at any time over the duration of the contract, the contract will not be treated as providing only life insurance for tax purposes. Rather, the contract may be treated as providing a combination of term life insurance with an annuity or a deposit fund (depending upon the terms of the policy).

A flexible premium life insurance contract is a life insurance contract which provides for the payment of one or more premiums that are not fixed by the company as to both timing and amount. Thus, under such a contract, the insurance company may fix the timing of the premium payments but not the amount, the amount of the premiums but not the timing, or neither the timing nor the amount of the premiums. For example, an indeterminate premium policy would not come within the definition of a flexible premium life insurance contract because, typically, the insurance company fixes the timing of the premium payments upon issuance of the contract and the insurance company, not the policyholder, fixes (and periodically adjusts) the amount of each future premium payment. The policyholder must pay the amount that the company prescribes, neither more nor less, and must pay it at the time prescribed in order to prevent the contract from being in default. The term "flexible premium life insurance contract" also includes contracts that provide for certain qualified additional benefits, specifically, family term life insurance (e.g., for the insured, a spouse or a child), an accidental death benefit, a waiver of premium benefit, and a guaranteed insurability benefit. The terms used in listing the four specific qualified additional benefits are generally descriptive. Thus, the "waiver of premium" benefit is intended to include, also, a waiver of the cost of insurance charge benefit. However, the inclusion of an additional benefit that does not come within these generally descriptive terms can disquality the contract for purposes of the new guidelines. For example, if a benefit rider providing term life insurance for a nonfamily member is added to the contract, such contract does not qualify as a flexible permium life insurance contract under these provisions.

The statute states that the term "flexible premium life insurance contracts" does not include that portion of any contract that is treated under State law as providing any annuity benefits other than as a settlement option. Thus, although a flexible premium life insurance contract may provide by rider for annuity benefits, the annuity portion of the contract is not part of the flexible premium contract for tax purposes and such annuity benefits may not be reflected in computing the guideline premiums. Likewise, an insurance arrangement *written* as a combination of term life insurance with an annuity contract, or with a premium deposit fund, is not a flexible premium life insurance contract for purposes of the guidelines because all the elements of the contract provisions and contract values are not subject to the provisions of State law regulating life insurance. However, any flexible premium contract that is treated under State law as a single integrated life insurance contract and that satisfies these guidelines will be treated for Federal tax purposes as a single contract of life insurance and not as a contract that provides separable life insurance and annuity benefits.

Finally, the guidelines contain alternative tests which a contract may meet in order for the death proceeds therefrom to be treated as life insurance for tax purposes.

Alternative 1—guideline premium with limited cash value

The first test provides that two requirements be met at all times: (1) the sum of the premiums paid under the contract at any time cannot exceed a specifically computed guideline premium limitation; and (2) the amounts payable on the death of the insured cannot be less than a certain multiple of the contract's cash value as of the date of death. For purposes of applying the first requirement, the sum of the premiums paid includes premiums for any additional qualified benefits as well as the primary death benefit. However, the amount of premiums paid should be reduced by any amounts received by the policyholder and not includible in income under section 72(e).

A premium payment that causes the sum of the premiums paid to exceed the guideline premium limitation will not result in the contract failing the guidelines if the premium payment is necessary to prevent termination of the contract on or before the end of the contract year. Also, if it is established to the satisfaction of the Secretary that the first requirement was not met due to reasonable error and reasonable steps are being taken to remedy the error, the Secretary may waive the first requirement. If a premium that causes the first test to be violated is returned (together with interest allocable thereto) within 60 days after the end of any policy year, the first test will be deemed to have been satisfied at all times during the contract year preceding the return of the premium. The interest returned with such a premium is includible in the policyholder's income currently notwithstanding the general rules of section 72(e).

The premium limitation in the first test is intended to prevent investment motivated contributions of large cash amounts to the contract. The guideline premium limitation means, on any date, the greater of: (1) the single premium at issue necessary to fund the future benefits provided under the contract, based on mortality and other charges fixed in the contract (including expense charges) and based on interest at the greater of 6 percent or the minimum rate or rates guaranteed in the contract; or (2) the sum of the level annual amounts payable over the longest period permitted under the contract (but not less than 20 years from date of issue or not later than age 95, if earlier), computed on the same basis as the single premium except that the interest rate used cannot be less than 4 percent. For purposes of computing the guideline premium, charges for qualified additional benefits are appropriately discounted and taken into account as part of the guideline premium.

In calculating the guideline premiums, on a single premium basis and in certain other situations, the inclusion of a qualified additional benefit can have an impact on the value of the future benefits relating to the basic life coverage of the contract. For example, under a universal life policy with a death benefit equal to a specified amount (as opposed to a benefit equal to a level risk amount plus the cash value at death), the addition of a single premium for a qualified additional benefit will tend to increase the policy's cash value and thereby to reduce the "net amount at risk" with respect to the basic life coverage under the policy. In computing the guideline premiums, it would be appropriate to reflect this interaction in the computation.

Likewise, the inclusion of a qualified additional benefit can also impact on the computation of the guideline level premium. If a qualified additional benefit is scheduled to cease at a certain age, the charges for such qualified additional benefit should be reflected in a level manner in the guideline level premium only over the period such charges are being incurred, despite the fact that the longest premium payment period under the policy, in general, extends beyond that period. This interpretation recognizes that separate policy benefits can have discrete payment periods. Likewise, it prevents the anomalous result of requiring some degree of post-funding of charges for certain qualified additional benefits should the longest (though inapplicable) premium payment period be used. Hence, if premiums are payable to age 95, and a qualified additional benefit ceases at age 65, the guideline level premium up to age 65 will be higher (reflecting the charges for the qualified additional benefit) than it will be over the period from age 65 to age 95.

In defining the guideline single premium the statute refers (1) to the mortality and other charges guaranteed under the contract and (2) to interest at the minimum rate or rates guaranteed upon issue of the contract. In order to give meaning to these phrases as definitional limitations on the contract obligations of the issuing insurance company, the term "the mortality and other charges" means the maximum charges guaranteed at issue for the life of the contract, and the term "minimum rate or rates" means the floor rate or rates of interest guaranteed at issue of the contract. Thus, although the company may guarantee a higher interest rate from time to time, either by contractual declaration or by operation of a formula or index, the minimum rate still should be taken to be the floor rate, that is, the rate below which the interest credited to the contract cannot fall. The statutory reference to minimum rate or rates recognizes that a contract may guarantee different floor rates for different periods of the contract, although each is guaranteed at issue and remains fixed for the applicable period for the life of the contract. However, it should be noted that when the initial interest rate guaranteed to be credited to the contract is in excess of the generally applicable floor rate assumed in the contract, the higher initial interest rate is the minimum or floor rate with respect to the initial period of that guarantee. This is because that rate is guaranteed at issue and, for the initial guarantee period, the interest rate cannot fall below that guaranteed rate. Similarly, although the contract may have generally applicable assumptions for mortality and other charges, any deviations in these charges that are guaranteed at issue, though even for a short time, would be the maximum charges with respect to the initial guarantee period. Aside from taking into account initial guarantees that are different from the generally applicable charges and interest rates assumed in the contract, the Act does not require that any "excess interest" (interest credited at a rate in excess of any rate or rates guaranteed in the contract at the time of issue), or any reduction in the mortality charge below the maximum chargeable, be taken into account in the computation of the guideline premiums.

The Act also contains three computational rules for the guideline premiums, which are designed to limit the range of future benefits that may be assumed in computing such premiums. First, the net amount at risk assumed to exist at any time in the future of the contract cannot exceed the comparable amount existing when the contract is issued. Absent such a rule, the guideline premiums could be artifically raised by assuming increased future death benefits even though there is no intention to keep the contract in force until those benefits are actually effective. For purposes of this rule, the net amount at risk upon issue would be the face amount of the policy when it is issued, reduced by the cash value resulting from the initial premium. This would be true whether the death proceeds of the contract are defined as a level face amount or as a level specified amount plus the policy's cash value at death. Also, the cash value of the contract (one of the factors that determines the net amount at risk) is the cash value accumulated by using the same assumptions concerning interest rates, mortality charges, and other charges used to compute the guideline premiums. Second, the maturity date of the contract is the latest date permitted under the contract, which cannot be less than 20 years after the contract is issued or age 95, if earlier. Third, the amount of any endowment benefit (*i.e.,* the benefit payable if the insured survives to the contract's maturity date) cannot exceed the smallest death benefit (determined without regard to any qualified additional benefits) at any time under the contract. This rule is designed to require that guideline premiums be computed on a basis consistent with premium computations for a traditional endowment policy, where the endowment benefit generally equals the death benefit. Under this rule, if the death proceeds of a policy equal a level specified amount plus the policy's cash value at death the endowment benefit will reflect the cash value produced by the initial premium payment because under such a policy, presumably, the death benefit upon issue will be the lowest death benefit payable over the life of the policy.

At the start of the contract the guideline premiums are based on the future benefits specified in the contract as of such date. If future contract benefits are changed at a subsequent date, the guideline premiums must be adjusted (upward or downward) to reflect the change. Such adjustments should not be made for increases in the death benefit that reflect excess interest that has been credited. A colloquy between Senator Dole and Senator Bentsen (128 Cong. Rec. S10943, August 19, 1982) explained that the guideline premiums are to be adjusted only in two circumstances. First, they are to be adjusted if the amount or pattern of a policy's benefits (including qualified additional benefits) is changed by the policy owner. For this purpose, if a qualified additional benefit ceases for any reason, including the death of an individual (such as the insured's spouse) insured thereunder, this is considered a change in benefits requiring an adjustment of the guideline premiums. Second, the guideline premiums are to be adjusted upon the occurrence of a change in benefits previously scheduled under the contract that could not earlier be taken into account in the calculation of the guideline premiums because of the "computational" rules set forth in section 101(f)(2)(D). The colloquy further noted that these adjustments are to be computed in the same manner as the initial guideline premiums, but based on the change in the amount or pattern of the benefits and the insured's attained age at the time of the change. The computational rules apply to the change in amount at the time of change independently of their application at issue or for a previous change. The colloquy recognized, however, that the Treasury may determine in regulations that some other method of computing adjustments is to be used instead. This adjustment rule is consistent with the statutory language of the premium test that the sum of the premiums paid at any time not exceed the guideline limitation at such time.

The second requirement provides a restriction on the death benefit in order to ensure that flexible premium contracts offer at least a minimum amount of pure insurance protection at all times. For purposes of meeting the second requirement, the death benefit under a flexible premium contract must be 140 percent of the cash value if the insured has an attained age of 40 or less at the beginning of the contract year; thereafter, the percentage is reduced by one percent for each year until the insured has an attained age of 76. In this context "attained age" can appropriately be read as meaning the insured's age determined by reference to contract anniversaries rather than the individual's actual birthdays. So long as the age assumed by the contract is within 12 months of the insured's actual age, then it is reasonable to use that age as the "attained age". The sliding scale for the death benefit ensures that the policy provide a minimum amount of pure insurance protection at all times.

Example for computing the guideline premium limitation

Option 1 death benefit.—Assume that a flexible premium life insurance contract is issued on the life of a male, age 35, for a death benefit defined as a "specified amount" equal to $100,000 (or, if greater, the contract's cash value at the time of the insured's death multiplied by the applicable percentage as set forth in section 101(f)(1)(A)(ii) and (3)(C)). The contract's guaranteed rate of interest at issue is 10 percent in the first contract year and 4 percent thereafter; the contract matures when the insured reaches age 95. The contract's guaranteed charges for mortality are based on the 1958 CSO Mortality Table, age last birthday, curtate functions, except that the rates in the first contract year are based on 75 percent of 1958 CSO mortality; for expenses, the charges are 10 percent of gross premiums plus $3.00 per $1,000 of specified amount at issue (or $3.00 per $1,000 of increase in the specified amount at the time of increase). These charges and credits are processed on an annual basis.

The guideline premium limitation means, as of any date, the greater of the guideline single premium, or the sum of the guideline level premiums to such date. The statute provides that the guideline single premium is the premium at issue necessary to fund future benefits under the contract, based on the mortality and other charges (including expense charges) guaranteed under the contract and based on interest at the greater of 6 percent or the minimum rate or rates guaranteed upon issue of the contract. Therefore, under the facts of the example, the guideline single premium is equal to the net single premium for a life insurance contract with an endownment at age 95, plus the expense charges specified under the contract. The net single premium is computed on the basis of assumed rates of interest of 10 percent for the first policy year and 6 percent thereafter and on the basis of a mortality charge of 75 percent of the 1958 CSO mortality for the first policy year and the 1958 CSO mortality thereafter. The statute provides that the guideline level premium is the level annual amount that is payable over the longest period permitted under the contract (ending not less than 20 years from the date of issue or not later than age 95, if earlier), computed on the same basis as the guideline single premium, except the interest rate must be the greater of 4 percent or the minimum rate or rates guaranteed in the contract. Thus, under the facts of the example, the guideline level premium is equal to the guideline single premium divided by the annuity value of the contract, where the annuity value is computed on the same basis as the guideline single premium except that the assumed rate of interest for the second policy year and later is 4 percent.

Based on the facts of the example, the guideline premiums and the guideline premium limitation are:

Contract duration	Guideline single premium	Sum of guideline level premiums	Guideline premium limitation
At issue	$17,219	$1,590	$17,219
Year 10	17,219	15,900	17,219
Year 20	17,219	31,800	31,800
Year 30	17,219	47,700	47,700

Assume that ten years later the specified amount is increased to $125,000 (the insured is age 45). The contract's guaranteed rate of interest in the first contract year after the increase is 8 percent, and in that year the mortality rates are guaranteed to be 75 percent of the 1958 CSO mortality. The statute provides that the guideline single premium and the guideline level premium must be adjusted if there is a change in future benefits under the contract that was not reflected in the guideline premiums previously determined. Any adjustment is computed in the same manner as the initial guideline premium computations, but taking into account any changes. Thus, under the facts of the example, the guideline single premium of $17,219 is adjusted by $6,774, to become $23,993. Also, the guideline level premium of $1,590 is adjusted by $631, to become $2,221. The guideline premiums and the guideline premium limitation then will be:

Contract duration	Guideline single premium	Sum of guideline level premiums	Guideline premium limitation
Year 10 (before increase)	$17,219	$15,900	$17,219
Year 11	23,993	18,121	23,993
Year 20	23,993	38,110	38,110
Year 30	23,993	60,320	60,320

Option 2 death benefit.—Also, many flexible premium life insurance contracts provide for a death benefit that is defined as the contract's cash value at death plus a level "specified amount" (though never less than the cash value multiplied by the applicable percentage under section 101(f)(1)(A)(ii) and (3)(C)). Assume that all other facts remain as stated under option 1, except that an option 2 death benefit is chosen. Assume that the specified amount is $100,000 and that a premium of $20,000 is paid at issue. After the payment of the $20,000 premium, the cash value of the contract is $17,524 (which is the premium paid less the expenses charges and the mortality charge for the first policy year). The statute provides that any endowment benefit assumed in computing the guideline premiums cannot exceed the least death benefit payable at any time under the contract. As the cash value will generally increase over the life of the contract, the initial death benefit is the least death benefit in this example. Thus, the endowment assumed in computing the guideline premiums cannot exceed $117,524 (the specified amount plus the initial cash value).[12] Assuming an endowment benefit of $117,524 at age 95, under option 2, the guideline single premium is equal to that endowment benefit discounted at interest and mortality to the date at issue, plus the expense charges specified.[13] It should be noted that the computation for option 2 assumes a pattern of benefits in which the death benefit always consists of the specified amount ($100,000) plus the cash value. The guideline level premium is computed, as under option 1, by dividing the guideline single premium by the annuity value. Thus, upon issue of the contract with the option 2 death benefit, the guideline premiums and the guideline premium limitation are:

---

[12] Based on the facts assumed, for an option 2 death benefit with a specified amount of $100,000, the maximum guideline single premium that may be computed is $40,713, assuming the payment of such amount as the premium at issue. If the maximum guideline single premium were paid initially, the maximum endowment benefit that can be assumed is equal to $136,166.

[13] The assumed interest rates, mortality charges and other charges are the same used under option 1.

Contract duration	Guideline single premium	Sum of guideline level premiums	Guideline premium limitation
At issue	$40,108	$3,934	$40,108
Year 10	40,108	39,340	40,108
Year 20	40,108	78,680	78,680
Year 30	40,108	118,020	118,020

When the specified amount in the option 2 case is later increased to $125,000 (again, when the insured is age 45), and an additional premium of $10,000 is paid at such time, the guideline single premium is adjusted by $17,210, and the guideline level premium is adjusted by $1,510. The new figures are:

Contract duration	Guideline single premium	Sum of guideline level premiums	Guideline premium limitation[14]
Year 10 (before increase)	$40,108	$39,340	$40,108
Year 11	57,318	44,784	57,318
Year 20	57,318	93,780	93,780
Year 30	57,318	148,220	148,220

[14] The endowment benefit, after the adjustment, is assumed to equal $151,352. The maximum guideline single premium adjustment that may be computed is $17,616, based upon the payment of such amount as a premium at the time of adjustment (and assuming an endowment benefit of $176,849).

Alternative 2–cash value computation

The second test is a specific cash value test patterned after a traditional whole life policy. That is, death proceeds paid from a flexible premium life insurance contract will be excluded from the beneficiary's gross income if, by the terms of the contract, the cash value may not exceed at any time the net single premium for the amount payable by reason of the death of the insured (without regard to any qualified additional benefit) at such time. Thus, the net single premium must be adjusted (upward or downward) to reflect increases or decreases in the death benefit provided under the policy. This is required by the language of the cash value test itself, even though the statute does not specifically call for the adjustment as it does with the first alternative test. For these purposes, the net single premium must be computed by using the mortality basis guaranteed under the contract but determined by reference to the most recent mortality table allowed under all State laws on the date of issue; an interest factor that is the greater of 4 percent (3 percent for contracts issued before July 1, 1983) or the rate guaranteed in the contract; and the computational rules for the guideline premium, except that the maturity date of the contract cannot be earlier than age 95. The phrase "the most recent mortality table allowed under all State laws" should be read literally and refers to that mortality table, appropriate to the particular insurance plan, that has been adopted and is permitted to be used by companies in all fifty States. The requirement of referring to the most recent mortality table is intended to prevent a company from using a guaranteed mortality basis which, on the date of issuance, is outdated and is replaceable by a more modern basis. Thus, the statute requires that the most recent mortality table be used as a measuring rod, that is, that the net single premium computed on the guaranteed mortality basis cannot exceed that which would result if it were computed on the basis of the most recent mortality table. For example, in addition to the most recent mortality table adopted and permitted to be used in all fifty states, a company may use a more recent table adopted and permitted in the State in which a contract is issued, or any other table that results in a smaller net single premium.

Effective Dates

In general, the provisions regarding flexible premium life insurance contracts apply to all such contracts issued before January 1, 1984.

The Act provides two special transition rules for contracts issued before January 1, 1983. First, any such contract that is in compliance with the new provisions on the date one year after the date of enactment of the Act will be treated as meeting all the requirements of the provisions retroactively. For purposes of bringing a contract into compliance with the new provisions, it will be sufficient for the guideline premium limitation to be computed on the assumption that the benefits at the time of the computation have been in effect since the time of issue. Such an assumption avoids the necessity of reconstructing guideline premiums and adjustments for past benefit changes under a policy for which historical data may be limited and implements the spirit of the grandfather provisions applicable to existing contracts. Likewise, in bringing a contract into compliance, if on the date of computation of the guideline premium limitation the sum of the premiums paid exceeds such limitation, amounts removed from the policy and returned to the policyholder need not include interest paid on such amounts. Although the new guideline provisions require that interest be paid on premiums returned to a policyholder in order to maintain compliance with the guidelines, such provisions are inapplicable until an existing contract is brought into compliance with the guidelines. Second, any such contract shall be treated as meeting the first alternative test if it would meet the requirements of the provision by using 3 percent instead of 4 percent for computing the guideline level premium. Finally, the Act provides a grandfather provision for any death benefits paid within the first year of enactment under a flexible premium contract issued before January 1, 1983; such benefits are excluded from gross income whether or not the contract is in compliance with the guidelines.

9. Grandfathering for treatment of indeterminate premium policies (sec. 263 of the Act and secs. 309(c) and 811 of the Code)*

Prior Law

In recent years, stock companies have begun to offer "indeterminate premium" policies under which the company charges a premium lower than the maximum premium fixed in the policy. Such lower premiums are charged to the policyholder on a temporary basis (typically for 1 year) because the rate of interest that companies can assume in setting policy benefits is limited as a practical matter by State law. In computing taxable income, companies have taken the reporting position that only the payments that are actually received under the indeterminate premium policies are included in gross income.

In a widely publicized private letter ruling, issued in June, 1982, the Internal Revenue Service held, among other things, that the excess of the maximum premium chargeable over the premium actually collected should be treated as a distribution of policyholder dividends, which is then treated as paid back as a premium to the company.

Reasons for Change

Congress believed that it was appropriate to provide grandfathering protection against audit reclassification of prior reporting practices for indeterminate premium policies because of their uncertain legal status.

Explanation of Provision

For taxable years beginning before 1982, the Act provides that amounts that could have been charged as a premium or mortality charge, but were not, are not to be included in premium income (sec. 809(c)(1)).

No inference is to be drawn as to the treatment of these premiums or mortality charges for taxable years beginning after 1981 as a result of the provision.

Effective Date

The provision is effective for taxable years beginning before 1982.

---

* For legislative background of the provision, see: H.R. 4961, as reported by the Senate finance Committee, sec. 265; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), p. 355; and H. Rep. No. 97-760 (August 17, 1982), p. 649 (Joint Explanatory Statement of the Committee of Conference).

10. Underpayments of 1982 estimated taxes (sec. 268 of the Act and sec. 6655 of the Code)[*]

Prior Law

A corporation generally must make payments of its estimated tax liability for the taxable year. The estimated tax is payable in up to four installments over the taxable year.

In general, if estimated tax payments are not equal to at least 80 percent of the tax due, a nondeductible penalty equal to the interest that would accrue on the unpaid tax is imposed on the amount of the underpayment for the period of underpayment. However, the underpayment penalty does not apply if, before the due date of any installment, the corporation pays an installment based on:

(1) the corporation's tax liability for the prior year,

(2) the corporation's tax liability on the prior year's income computed using tax rates for the current year, or

(3) 80 percent of the tax which would be due if the corporation's annual income were equal to the amount which would result if the corporation continued to receive income during the remainder of the year at the same rate experienced up to the date of the installment (i.e., the corporation's income computed on an annualized basis).

Reasons for Change

Several provisions under the Act will increase the 1982 tax liabilities of life insurance companies because those provisions are effective in 1982. For example, the repeal of the modified coinsurance provisions applies as of January 1, 1982, and the reduction in the formula used to revalue reserves computed on a preliminary term basis applies after March 31, 1982. Because these changes would not have been taken into account for 1982 estimated tax installments due before the changes are actually enacted, Congress believed that the underpayment penalty that would otherwise apply to those installments should be waived to the extent tax increases are attributable to legislative changes.

Explanation of Provision

The Act provides that the addition to tax for failure to pay the corporate estimated tax is waived for any underpayment period ending before December 15, 1982, to the extent the underpayment was created or increased by the provisions of the bill. If the underpayment is not paid on or before the date prescribed for the third installment (December 15, 1982 for calendar year taxpayers under sec. 6154(b)), the underpayment period for the prior installments eligible for the waiver will, in effect, commence on December 15, 1982, for purposes of applying the underpayment penalty.

---

[*] For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 269; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp 356-357; and H. Rep. No. 97-760 (August 17, 1982), p. 649 (Joint Explanatory Statement of the Committee of Conference).

Effective Date

The provision is effective on the date of enactment of the Act for underpayment periods occurring prior to December 15, 1982.

11. Revenue Effect of Insurance Provisions

The insurance provisions of the Act are expected to increase net fiscal year budget receipts by $1,942 million in 1983, $2,155 million in 1984, $2,920 million in 1985, $3,138 million in 1986, and $3,370 million in 1987.

F. Employment Tax Provisions

1. Independent Contractors*

a. Alternative standards for determining classification of workers for employment tax purposes and extension of certain interim provisions (sec. 269 of the Act and new sec. 3508 of the Code)

Prior Law

Overview

Common law (i.e., nonstatutory) rules generally apply in determining whether particular workers are treated as employees or as independent contractors (self-employed persons) for Federal employment tax purposes. However, certain individuals are classified by the tax statute as employees for FICA (social security) tax purposes. These statutory FICA employees are certain agent-drivers or commission-drivers, full-time life insurance sales persons, home workers performing services on goods or materials, and full-time traveling or city sales persons.

Interim provisions relating to classification controversies

Section 530 of the Revenue Act of 1978 provided that taxpayers who had a reasonable basis for not treating workers as employees in the past could continue such treatment without incurring employment tax liabilities. This relief was available only if the taxpayer filed all Federal tax returns (including information returns) that are required to be filed with respect to workers whose status is at issue on a basis consistent with the taxpayer's treatment of the workers as independent contractors. Also, the 1978 Act prohibited the Treasury Department from issuing any regulation or revenue ruling that classifies individuals for purposes of employment taxes under interpretations of the common law.

The interim provisions of section 530 of the Revenue Act of 1978 were extended, by subsequent legislation, through June 30, 1982.

Reasons for Change

During the late 1960s, and continuing into the 1970s, the Internal Revenue Service increased the number of its employment tax audits. As a result of these increased audits, controversies developed between the Internal Revenue Service and some businesses concerning the proper classification of workers.

---

* For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, secs. 271-274; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 358-374; and H. Rep. No. 97-760 (August 17, 1982), pp. 650-652 (Joint Explanatory Statement of the Committee of Conference).

The interim relief provisions of the Revenue Act of 1978 were intended to provide a temporary solution to the problems arising from increased employment tax status controversies. Those provisions were enacted, and subsequently extended, to afford Congress adequate time to adopt a permanent solution to the complex issues involved in this area of the tax law.

A major portion of the employment tax status classification controversies that arose prior to the implementation of the interim relief provisions of the 1978 Act focused upon workers who were involved either in direct selling activities or real estate sales. Congress believed that it was these workers who were most in need of an immediate solution to the problem of proper employment tax status. Thus, the Act provides a statutory scheme for assuring the status of certain direct sellers and real estate sales persons as independent contractors. However, because this provision does not cover all types of workers who were involved in employment tax status controversies, Congress also decided to extend, for an indefinite period of time, the interim relief provisions of the 1978 Act. This will enable Congress, in the future, to determine whether a broader statutory scheme for determining employment tax status would be desirable.

Explanation of Provisions

The Act establishes two categories of statutory nonemployees: (1) qualified real estate agents and(2) direct sellers. If certain conditions are satisfied, sales persons who are licensed real estate agents and individuals who are direct sellers will be treated, for Federal income and employment tax purposes, as self-employed persons.

In addition, the Act extends, indefinitely, the interim relief provisions of the 1978 Act.

Qualified real estate agents

Three conditions must be satisfied in order for an individual who is a sales person to be a qualified real estate agent. First, the individual must be a licensed real estate agent. Second, substantially all of the remuneration (whether or not paid in cash) for services performed by the individual as a real estate agent must be directly related to sales or other output rather than to the number of hours worked. For purposes of this requirement, the term "other output" includes the performance of services. Finally, the services performed by the individual must be performed pursuant to a written contract between the individual and the person for whom the services are performed. This contract is required to provide that the individual will not be treated as an employee with respect to those services for Federal tax purposes.

In defining qualified real estate agents, the Act's reference to sales persons who are licensed real estate agents includes the appraisal activities of licensed real estate agents in connection with real estate sales activities if such individuals realize remuneration dependent on sales or other output.

Direct sellers

The Act also sets forth three conditions that must be satisfied in order for a person to qualify as a direct seller. First, the person either must be (1) engaged in the trade or business of selling (or soliciting the sale of) consumer products to any buyer on a buy-sell basis, a deposit-commission basis, or any similar basis prescribed by regulations, for resale (by the buyer or any other person) in the home or otherwise than in a permanent retail establishment, or (2) engaged in the trade or business of selling (or soliciting the sale of) consumer products in the home or otherwise than in a permanent retail establishment. Second, substantially all the remuneration (whether or not paid in cash) for the performance of the direct selling services must be directly related to sales or other output (including the performance of services) rather than to the number of hours worked. Finally, the services performed by the person must be performed pursuant to a written contract between such person and the person for whom services are performed and the contract must provide that the person will not be treated as an employee, with respect to such services, for Federal tax purposes.

In defining direct sellers, the Act's reference to individuals engaged in the trade or business of selling or soliciting the sale of consumer products includes the activities of individuals who attempt to increase direct sales activities of their direct sellers and who realize remuneration dependent on the productivity of those direct sellers. These activities include providing motivation or encouragement, imparting skills, knowledge, or experience, or recruiting activities.

Retirement plans for self-employed individuals

The Act provides that the provision will not apply to the extent that an individual is treated as an employee under Code section 401(c)(1) (relating to self-employed individuals). Thus, the fact that an individual is treated as a nonemployee for purposes of FICA, FUTA, and Federal income tax withholding, will not prevent the individual from being covered under a qualified retirement plan for self-employed individuals.

Extension of interim relief

The Act indefinitely extends the interim provisions (section 530 of the Revenue Act of 1978) from July 1, 1982, until such time as Congress enacts legislation as to the classification of workers as independent contractors or employees. This provision does not prohibit implementation (e.g., through issuance of regulations or rulings) of the provision in the Act relating to statutory nonemployees.

Effective Date

The provision relating to statutory nonemployees applies to services performed after December 31, 1982.

Revenue Effect

The provision is expected to reduce fiscal year budget receipts by $117 million in 1983, $107 million in 1984, $79 million in 1985, $85 million in 1986, and $92 million in 1987.

b. Reduction of certain employment tax liabilities where workers are reclassified as employees (sec. 270 of the Act and new sec. 3509 of the Code)

Prior Law

Three major problems may arise if a worker who has been treated as an independent contractor is reclassified as an employee:

(1) The business whose workers are reclassified may be assessed FICA and FUTA employment taxes for years for which such assessments are not barred by the statute of limitations.

(2) Overpayments of income taxes may occur if the business is required to pay amounts as withholding of employee income tax liabilities with respect to which workers already had paid income tax (through estimated tax payments or with their returns).

(3) Overpayments of social security taxes may occur if the business is required to pay FICA taxes with respect to workers who already had paid self-employment (SECA) taxes.

If a worker reclassification occurs, the employer generally is responsible for all employment tax liabilities (income tax withholding, both the employer's and the employee's share of FICA taxes, and the FUTA taxes) with respect to the reclassified worker. Federal income tax withholding assessments may be adjusted if the reclassified worker pays (or has paid) the proper amount of income tax (sec. 3402 (d)). However, the employer generally is not relieved of any applicable penalties or additions to tax for failure timely to pay over amounts as withholding.

The reclassified worker's share of FICA tax often is not adjusted to reflect the amount of SECA tax already paid on the same income. This is because present law (sec. 6521) authorizes a FICA-SECA offset only if the worker who has been reclassified as an employee is prevented from filing for a refund of the SECA tax paid in error. This may result in the double collection of the employee's portion of social security tax: (1) once from the business as the FICA tax it initially failed to withhold from the reclassified employee, and (2) once from the employee as the SECA tax previously paid in error, if the employee could obtain a SECA tax refund but fails to do so.

Reasons for Change

Congress was aware that the employment status controversies that led to enactment of the interim relief provisions of the Revenue Act of 1978 were aggravated by the serious retroactive tax burdens that may arise when a worker who has been treated as an independent contractor is reclassified as an employee.

Congress understood that, in a reclassification case, the Internal Revenue Service generally would adjust assessments for failure to withhold income taxes if the employer could furnish certificates, signed by the reclassified workers, showing that they had paid the taxes. However, in situations involving many workers and a high turnover rate, or in situations involving workers who were uncooperative or who maintained inadequate records, obtaining evidence to show whether the workers had paid the proper amounts of income taxes could be a difficult burden on the business. If certificates were not provided, the Internal Revenue Service generally would not provide information from its own records regarding employee tax payments unless discovery of such records was ordered in the context of civil litigation contesting the assessment.

Congress also understood that even where information on employer tax payments was available, problems arose with respect to possible double collection of social security taxes.

Accordingly, the Act provides a statutory offset mechanism that will apply in reclassification cases. This provision represents a substantial simplification of prior law procedures and will reduce burdens on employers whose workers are reclassified.

Explanation of Provision

The Act provides a new procedure for determining an employer's liability for failure to withhold income taxes or the employee's share of FICA taxes in certain situations involving worker reclassifications. Even where this procedure applies, however, the employer still will be liable for the employer's share of FICA taxes and FUTA taxes.

If an employer treats services performed by an employee as if performed by a nonemployee and fails to withhold income or social security taxes as required by the wage withholding provisions of the income tax and social security tax laws, the employer's liability for those amounts will be determined as a fraction of the employee's wages subject to income tax withholding or a fraction of the social security taxes required to be withheld. The fraction in the Act is designed to approximate the average amount of liability the employer would incur under prior law after reducing the employer's initial liability by the amount of taxes paid by the employee. The Act applies a lower fraction if the employer has complied with information reporting rules consistent with the treatment of the employee as a nonemployee. This lower fraction reflects the increased tax compliance that results when information reports are filed with the Internal Revenue Service.

The applicable amounts are 1.5 percent of wages (3 percent where no information returns are filed) where the employer erroneously treated the worker as a nonemployee for income tax purposes. The applicable amount where the employer erroneously treated the worker as a nonemployee for social security purposes is 20 percent of the social security taxes required to be withheld (40 percent where no information returns are filed).

In a typical reclassification case, an amount for both income and social security taxes will be assessed. In some reclassification cases, however, the employer may treat the worker as an employee for social security purposes but not for income tax purposes, in which case only the income tax amount will be assessed.

Where the employer treats the worker as an employee for income tax purposes but not for social security tax purposes, these provisions will not apply; instead, the provisions in effect prior to the Act will apply.

Although these fractional amounts are set at levels reflecting assumed levels of taxpayer compliance, Congress believes that the amounts also reflect appropriate sanctions for an employer's erroneous failure to withhold taxes from compensation paid to an employee, regardless of the actual level of taxpayer compliance in any particular case. Accordingly, Congress believes that the assessment of these amounts will serve the dual function of deterring noncompliance on the part of employers, and compensating the Treasury for the revenue loss typically associated with employer noncompliance with wage withholding.

These reduced amounts generally are to be treated as the tax the employer should have withheld and paid currently under Code sections 3402 or 3102. The deductibility of these amounts is to be determined as if they were assessments for taxes that the employer failed to deduct and pay over, taking into account the Act's provisions denying the employer any right to claim reimbursement from the employee.

In order to deter intentional noncompliance with the wage withholding requirements, these provisions do not apply if the employer treats the employee as a nonemployee with intentional disregard of the law. Furthermore, the FICA tax liabilities of statutory FICA tax employees are not covered by these provisions.

Effective Date

This provision became effective on enactment. However, the provision does not apply to assessments made before January 1, 1983.

Revenue effect

The provision is expected to have a negligible effect on annual fiscal year budget receipts.

2. Federal Unemployment Tax Provisions*

a. FUTA tax rate and wage base (sec. 271 of the Act, sec. 3306 of the Code, and sec. 901 of the Social Security Act)

Prior Law

The Federal-State unemployment compensation system is financed by separate Federal and State payroll taxes on employers. Administrative funds are derived from the Federal payroll tax and benefits are paid mainly from State payroll taxes.

Under the Federal Unemployment Tax Act (FUTA), a payroll tax of 3.4 percent on the first $6,000 of wages was levied on employers who, in the current or last year, employed at least one person for 20 different weeks or had a quarterly payroll of at least $1,500. If a State's unemployment compensation program met the requirements of Federal law (see below), employers in the State received a 2.7 percent credit against the 3.4 percent Federal tax. Thus, under prior law, the standard net Federal tax rate in all States was 0.7 percent. (The tax rate was higher in certain States that had outstanding Federal unemployment loans.)

States also levy unemployment taxes on all covered employers in the State. These taxes finance regular State benefits and one-half the cost of Federal-State extended benefits. The method and level of taxation varies considerably among the States. All States (except Puerto Rico and the Virgin Islands) provide a system of experience rating under which State tax rates vary among employers according to the total amount of unemployment benefits that have recently been paid to former employees of each employer. In 1981, the estimated average State tax rate was 2.4 percent of taxable wages, ranging from 0.5 percent in Texas to 4.0 percent in Michigan. In 1982, all States have a wage base of at least $6,000. Twenty-five States have a higher wage base, ranging from $6,600 to $14,000. In Puerto Rico, taxes are paid on total wages.

The requirements of FUTA relating to State unemployment compensation taxes include: (1) all State unemployment compensation tax revenue must be deposited in the respective State accounts in the Federal Unemployment Trust Fund; (2) all money withdrawn from State accounts must be used only to pay benefits (or to refund erroneous tax contributions); and (3) the standard State tax rate levied on employers (which formerly had to be at least 2.7 percent) may be lower than 90 percent of the gross FUTA rate only on the basis of the particular employer's recent experience with unemployment.

---

* For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 275; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 376-377; Senate floor amendment, 128 Cong. Rec. S9019 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 653-656 (Joint Explanatory Statement of the Committee of Conference).

Reasons for Change

The Federal-State unemployment insurance system was in serious financial difficulty. Estimated FUTA receipts were inadequate to cover Federal unemployment benefit and administrative costs and employment service obligations. In addition, State trust fund accounts were severely strained.

Since the 1974–1975 recession, the Unemployment Trust Fund borrowed substantial sums from the Federal General Revenue Fund. Estimates by the Department of Labor (DOL) projected that total Trust Fund debt to the General Fund would rise from $13.1 billion at the end of fiscal year 1981 to $21.7 billion in fiscal year 1984, thereafter declining to $13.4 billion in fiscal year 1987.

A substantial portion of the Unemployment Trust Fund debt stemmed from State borrowing and the generally poor financial condition of many State accounts. Prior to 1974, although annual benefit payments exceeded State tax contributions in some States, total net reserves in most State accounts were believed sufficient to cover benefit expenditures. During the 1974–1975 recession, however, State net reserves declined sharply as benefit expenditures doubled and State tax contributions declined.

Further, despite positive overall total net reserves in State accounts in the early 1970's, between 1975 and 1978, 25 State UC programs became insolvent. By the end of fiscal year 1979, 25 States had borrowed over $5.6 billion, compared with total State borrowing of $100 million by three States prior to 1975.

As of June 1982, 19 States owed $7.8 billion in outstanding unemployment loans. DOL predicted that loans would increase during fiscal years 1982, 1983 and 1984, with additional net borrowing of $3.3 billion, $4.5 billion, and $2.2 billion respectively.

The adjustments in the FUTA tax and wage base in the Act provide new Federal and State revenue to help assure adequate financing of unemployment compensation administrative and benefit costs. The increase in the wage base is projected to produce new Federal revenues of $2.1 billion during fiscal years 1983 through 1986. Over the same period, $2.2 billion in additional Federal revenue will be derived from the increase in the net FUTA tax rate. State revenue over the four-year period is estimated to increase $4 billion in States which must make wage base and maximum tax rate adjustments. The combined Federal and State revenue increase, all of which is reflected in the Federal unified budget, is expected to be $1.4 billion in fiscal year 1983, $2.4 billion in fiscal year 1984, $2.7 billion in fiscal year 1985 and $1.9 billion in fiscal year 1986.

Depending on their personnel patterns, employers are affected differently by FUTA rate and base increases. The Act reflects the position that increasing both the FUTA tax rate and wage base is more equitable than concentrating the entire increase on either the rate or base alone.

The provisions of the Act which modify the FUTA rate and base were also intended to move State unemployment taxes toward a more fully experience-rated system. First, the restructuring of the FUTA tax, effective beginning in 1985, was intended to extend the States' experience-rated tax schedules so that the proportion of taxes paid by employers will more nearly equal the cost of benefits paid to their former employees. Under State experience rating systems, employers' tax rates are based on some factor, such as benefits paid out, in relation to the employers' payrolls. Actual tax rates are assigned according to tax schedules under which employers with the worst experience in terms of these ratios are assigned rates higher than those with better experience. Under the Act's provisions, the minimum tax rate charged by States to employers with the worst rating will be increased from at least 2.7 percent to at least 5.4 percent. In addition to distributing the burden of financing the system more heavily on the employers who use it the most, it is expected that the expanded experience rating will encourage employers to avoid layoffs, if possible, and to police claims against them more closely, since additional charges will result in increased payroll taxes.

Because the need for additional FUTA revenues is immediate, the increase in the gross tax rate to 3.5 percent and the net tax rate to 0.8 percent is effective January 1, 1983. This immediate increase can take place solely on the Federal level without necessitating accompanying adjustment of State laws and tax structures, which is normally a two-year process.

Explanation of Provision

Effective January 1, 1983, the Act increases the Federal unemployment tax wage base from $6,000 to $7,000. (This will require States, in order for employers to qualify for the 2.7 credit against the gross Federal tax rate, to have a State unemployment tax wage base of at least $7,000.)

The gross Federal unemployment tax rate is increased from 3.4 to 3.5 percent. Employers in States with approved State programs will continue to receive the 2.7 offset credit, so the standard net Federal tax will be 0.8 percent. This provision also is effective January 1, 1983.

Effective January 1, 1985, the Act increases the gross Federal tax rate to 6.2 percent. This includes a permanent tax of 6.0 percent plus a temporary 0.2 percent that will remain in effect until all outstanding general revenue loans to the Federal Extended Unemployment Compensation Account (EUCA) in the Unemployment Trust Fund have been repaid. The offset credit increases to 5.4 percent, so the net Federal tax rate will remain at 0.8 percent until the EUCA account has repaid all of general revenue loans, when it will drop to 0.6 percent. The wage base remains at $7,000.

Raising the permanent gross Federal tax rate to 6.0 percent and applying a 90-percent offset credit effectively requires an increase in the State "standard tax rate" from at least 2.7 percent to at least 5.4 percent (5.4 is 90 percent of 6.0). The State "standard tax rate" is the basic rate from which variations in employer's State unemployment tax rates are computed according to each State's experience rating formula. No employer in a State can pay a State tax below the standard rate unless his rate is reduced on the basis of the employer's previous unemployment experience, as measured by the State's experience rating system.

In other words, the effect of raising the permanent gross Federal tax rate to 6.0 percent is to require States which now have a maximum tax rate which is below 5.4 percent to increase that rate in order for employers in the State to qualify for the 90-percent reduction in the Federal gross tax rate. A State experience rating schedule will have to have potential tax rates ranging up to at least 5.4 percent. Because there is no minimum tax requirement, a State's experience rated schedule could result in employers in the State having tax rates that range from zero to at least 5.4 percent. If a State does not have an experience rated tax schedule and, therefore, imposes the same tax rate on all employers, under this provision that rate will have to be at least 5.4 percent. The Act does not change the present law provision which permits States to tax new employers at a rate as low as 1.0 percent until they qualify for a different tax based on their experience.

Table 2, following, summarizes the impact of Federal wage base and tax rate changes on State unemployment tax provisions. The wage base increase scheduled for January 1, 1983, has no effect upon State taxes in the twenty-one States that already taxed on a $7,000 or higher base shown in column (1) of the table. The States shown in columns (2) and (3) must move up to a $7,000 base from the current figure shown. This happens automatically under existing State legislation in the twenty-five States shown in column (2). Seven States, indicated in column (3), had wage bases under $7,000 but no statute automatically adjusting to the Federal base. These States have to enact conforming legislation.

Column (4) indicates maximum tax rates in States with prior maximums at, or above, 5.4 percent. Assuming those maximums are not reduced, they satisfy the "standard rate" that is required by January 1, 1985. The 32 States with prior maximums under 5.4 percent shown in column (5) have to implement a new range of rates with a maximum of at least 5.4 percent by January 1, 1985.

The Act permits States that, under State law in effect as of August 10, 1982, allow certain specified industries to pay a non-experience based State unemployment tax rate that is below 5.4 percent to allow such industries to reach gradually the new 5.4 standard tax rate. Annual increases in the State unemployment tax rate for such industries may be limited to no less than 20 percent of the difference between the rate paid by an employer as of August 10, 1982, and 5.4 percent.

Effective Date

The increase in the wage base to $7,000 and the increase in the rate to 3.5 percent are effective for wages paid after December 31, 1982. The increase in the tax rate to 6.2 percent and the increase in the credit rate to 5.4 percent are effective for wages paid after December 31, 1984.

Revenue Effect

This provision, including the other FUTA provisions below, increases fiscal year budget receipts by $1,404 million in 1983, $2,353 million in 1984, $2,729 million in 1985, $1,872 million in 1986 and $1,501 million in 1987.

TABLE 1.—SUMMARY OF STATE UNEMPLOYMENT TAX PROVISIONS AS OF JAN. 1, 1982

State	Taxable wage base			Maximum tax rate	
		Under $7,000 and:			
	$7,000 or higher	Provision to match FUTA base	No provision to match FUTA base	5.4 percent or higher	Under 5.4 percent
Alabama		$6,600			4.0
Alaska	$14,600				4.86
Arizona		6,000			2.9
Arkansas		6,900		5.5	
California			$6,000		4.2
Colorado		6,000			4.5
Connecticut	7,000			6.0	
Delaware			6,000	8.5	
District of Columbia	7,500			5.4	
Florida		6,000			4.5
Georgia		6,000			5.38
Hawaii	13,100				4.5
Idaho	13,200				4.0
Illinois	7,000			5.7	
Indiana		6,000			3.3
Iowa	8,700			6.0	
Kansas		6,000			4.3
Kentucky	8,000			10.0	
Louisiana		6,000			3.39
Maine		6,000			5.0
Maryland		6,000			5.0
Massachusetts		6,000		6.7	
Michigan		6,000		9.0	
Minnesota	8,300			7.5	
Mississippi		6,000			4.0
Missouri		6,600			5.2
Montana	8,000				4.4
Nebraska		6,000			3.7
Nevada	9,300				3.6
New Hampshire			6,000	6.5	
New Jersey	8,200			6.2	
New Mexico	8,500				5.1
New York			6,000		5.2
North Carolina		6,000		5.7	
North Dakota	9,240				5.0
Ohio		6,000			4.8
Oklahoma		6,000			3.1
Oregon	11,000				3.8
Pennsylvania			6,600	6.6	
Puerto Rico	(1)				2.95

TABLE 1.—SUMMARY OF STATE UNEMPLOYMENT TAX PROVISIONS AS OF JAN. 1, 1982—Continued

State	Taxable wage base			Maximum tax rate	
		Under $7,000 and:			
	$7.000 or higher	Provision to match FUTA base	No provision to match FUTA base	5.4 percent or higher	Under 5.4 percent
Rhode Island	8,600			6.0	
South Carolina		6,000			4.1
South Dakota		6,000		7.7	
Tennessee		6,000		7.0	
Texas			6,000		4.0
Utah	12,000				2.8
Vermont		6,000		6.0	
Virgin Islands	8,000				3.7
Virginia			6,000	6.9	
Washington	10,800				3.0
West Virginia	8,000			8.5	
Wisconsin		6,000		7.4	
Wyoming		6,000			2.7

[1] Total wages.

b. Allocation of FUTA revenues (secs. 271 and 275 of the Act and sec. 905 of the Social Security Act)

Prior Law

FUTA revenue flows into three Federal accounts in the Unemployment Trust Fund: (1) the Employment Security Administration Account (ESAA), (2) the Extended Unemployment Compensation Account (EUCA), and (3) the Federal Unemployment Account (FUA). ESAA finances administrative costs associated with Federal and State unemployment compensation and State employment service programs. EUCA finances the 50 percent Federal share of the Federal-State extended benefits program (EB), which provides up to an additional 13 weeks of benefits in States with high unemployment. FUA finances Federal loans to insolvent State unemployment compensation systems.

Title IX of the Social Security Act prescribes the flow of FUTA revenue into and among these accounts. Under prior law, the allocation of the net FUTA revenue was as follows:

(1) Approximately 65 percent of the revenue raised by the 0.7 percent FUTA tax (or 0.45 percentage points) went to ESSA where most of it, up to 95 percent, could be appropriated for State administrative grants and the remaining 5 percent was available to meet Federal administrative costs;

(2) The remaining 35 percent of the 0.7 percent FUTA tax revenue (or 0.25 percentage points) flowed into EUCA where it

was used to finance the Federal share of the EB program and certain other programs which provided extra weeks of benefits;

(3) When ESAA and EUCA statutory ceilings have been reached, any excess FUTA revenues flowed into FUA for use in granting loans to States.

Under prior law, the 0.7 percent net FUTA tax included a temporary surtax of 0.2 percent which was levied beginning in 1977 to generate funds to repay advances from the Federal General Fund to EUCA to meet the costs of the EB program. These outstanding advances currently total over $7.5 billion. When these advances have been repaid, the 0.2 percent temporary tax is no longer levied, and the net tax was to drop to 0.5 percent. In addition, the allocation to EUCA was to drop to 10 percent of the FUTA revenue (or 0.05 percentage points).

Reasons for Change

The shift in the allocation of revenues between the ESAA (administration) and EUCA (EB) accounts was intended to target a greater portion of the new revenues generated under the Act to EUCA than would have been the case under prior law. This reflected both a desire to repay the EUCA account as promptly as possible so that the 0.2 percent additional tax imposed in 1977 can be eliminated and the fact that allocating 60 percent of the total FUTA revenues to ESAA (instead of 65 percent as under prior law) was expected to provide enough funding to meet Federal and State administrative expenses without resorting to borrowing from general revenues. Any excess ESAA funds remaining at the end of a year flow into EUCA. Although the allocation to EUCA will drop from 40 to 10 percent of FUTA when the loans to the EUCA account are repaid, the net receipts flowing into EUCA will, because of the increased Federal wage base and rate, still be greater than they would have been under prior law. This allocation therefore, was expected to continue to generate funds sufficient to build adequate reserves in the EUCA account to cover future EB payments without resorting to Federal general revenues.

Explanation of Provision

The Act modifies the allocation of Federal unemployment tax revenues among accounts in the Federal unemployment trust fund to provide that 60 percent of the revenue raised by the net FUTA 0.8 tax rate which is effective January 1, 1983, (or 0.48 percentage points) will be allocated to the Employment Security Administration Account (ESAA) and 40 percent (or 0.32 percentage points) to the Extended Benefits Account (EUCA). The Secretary of Labor is required to make repayments to the General Fund of the Treasury from the EUCA account whenever he determines that the amount in the account exceeds the amount required to meet Federal extended benefit costs for the next 3 months. The Act also provides, upon repayment of the Federal general revenue advances to EUCA (and elimination of the 0.2 percent tax), that 90 percent of FUTA revenues will be allocated to ESAA and 10 percent of EUCA, as under prior law.

Effective Date

The provision is effective for FUTA tax liability with respect to remuneration paid after December 31, 1982.

c. Federal unemployment loans

(1) Loan repayment (sec. 272 of the Act and sec. 3302 of the Code)

Prior Law

A State that has depleted its own unemployment funds may receive Federal loans as necessary to pay regular State benefits. States that borrow funds have two to three years to repay the loan, depending on the month the loan is received. (A State has until November 10 of the calendar year in which the second consecutive January 1 passes with the State still having an outstanding advance. This means that a State may have from 22 months and 10 days up to 34 months and 10 days to repay the advance, depending on when it obtained the outstanding loan.)

Under prior law, if a State did not fully repay all loans within the two to three year period, employers in the State became subject to an annual reduction of at least 0.3 percent in the 2.7 percent offset credit against the gross FUTA tax. In other words, the net Federal unemployment tax rate became subject to annual incremental increases, of at least 0.3 percent up to a maximum of 3.4 percent, until sufficient revenue was raised to repay the State's entire outstanding loan balance. Under certain conditions, the annual reductions could be more than 0.3 percent beginning in the third and fifth year a State has an outstanding loan balance if the average State tax rate was less than (a) 2.7 percent or (b) beginning in the fifth year, the average of the last 5 years benefit expenditures divided by taxable wages.

Reasons for Change

In recent years the Unemployment Trust Fund has borrowed substantial sums from general revenues. The Fund debt was $15.4 billion at the end of fiscal year 1982 and is estimated to increase in fiscal 1983.

A substantial portion of Fund debt stems from State borrowing and the generally poor financial condition of many State accounts. As of July 1982, 19 States owed $7.8 billion in outstanding unemployment loans. Table 3 shows the loans made to each State. Additional State borrowing was expected in the remainder of fiscal year 1982 and in fiscal year 1983.

Employers in 11 States were subject to an annual reduction in the offset credit against the Federal unemployment tax because of delinquent State loans. Under prior law the Department of Labor estimated that nearly half the States would have been subject to reduced offset credits by fiscal year 1985. See Table 4 for the additional revenue estimated to be raised by credit reductions under prior law.

By permitting States, under certain conditions, to make loan repayments from State trust fund accounts in lieu of further FUTA offset credit reductions, the Act provides new flexibility to debtor

States. In addition, the provisions allow loan repayments to be made with revenues raised from an experience-rated tax structure.

Explanation of Provision

The Act allows States to make Federal unemployment loan repayments from State trust fund accounts in lieu of further reductions in the credit against the gross Federal unemployment tax rate, provided several requirements are met. First, the State account must have sufficient funds or sufficient income to enable it to repay an amount equal to at least the sum that the credit reduction would have generated plus any advances made to the State during the year. Second, after making this repayment, the State must retain enough funds in its account to pay all State benefits for the next 3 months (from November 1). Finally, the State must have made a change in its law, after the date of enactment of the Act, and after receiving the first advance, which has resulted in an increase in the solvency of its unemployment compensation system.

Effective Date

The provision is effective for taxable years beginning after December 31, 1982.

TABLE 3.—FEDERAL UNEMPLOYMENT LOANS TO STATES AS OF JULY 30, 1982

[In millions]

	Outstanding loans (as of June 30, 1982)	Estimated fiscal year 1982 loans	Estimated fiscal year 1983 loans
Alabama			$82
Arkansas	$64.0		44
Connecticut	272.0		34
Delaware	55.5	$18	11
District of Columbia	41.7		35
Illinois	1,634.1	674	647
Iowa		16	113
Kentucky	104.3	54	
Maine	21.3		19
Michigan	1,587.5	806	855
Minnesota	209.8	108	130
Missouri	89.8	90	42
New Jersey	525.6		119
Ohio	1,068.2	728	671
Oregon			24
Pennsylvania	1,608.7	292	626
Puerto Rico	66.4		
Rhode Island	102.0		22
South Carolina			28
Tennessee			2
Vermont	31.3		11

TABLE 3.—FEDERAL UNEMPLOYMENT LOANS TO STATES AS OF JULY 30, 1982—Continued

[In millions]

	Outstanding loans (as of June 30, 1982)	Estimated fiscal year 1982 loans	Estimated fiscal year 1983 loans
Virginia			45
Virgin Islands	3.0		
West Virginia	104.8	6	
Wisconsin	181.8	270	342

Source: U.S. Department of Labor/ETA/UIS Division of Actuarial Services.

TABLE 4.—ESTIMATED REVENUE FROM CREDIT REDUCTIONS UNDER PRIOR LAW, AS OF JULY 30, 1982[1]

[In millions]

State	Fiscal years					
	1982	1983	1984	1985	1986	1987
Alabama				20.3	77.3	95.1
Arkansas		10.8	29.4	33.9	34.7	
Connecticut	50.2	51.5	53.5	55.7	74.4	103.2
Delaware	7.4	7.5	11.8	12.2	12.7	
District of Columbia	11.1	11.4	17.9	24.7	32.1	40.1
Illinois	140.5	139.1	208.7	354.6	434.3	526.8
Iowa				15.0	30.7	47.8
Kentucky			16.1	32.8	33.5	
Maine	11.3	11.7	12.1	12.6	13.0	
Michigan		44.4	88.7	135.8	415.4	432.0
Minnesota		24.4	75.1	85.6	105.3	136.9
Missouri				27.0	55.0	
New Jersey	91.3	92.1	94.5	96.9	99.1	103.2
Ohio		61.0	122.1	186.7	550.4	594.4
Pennsylvania	134.2	135.5	208.4	284.7	364.9	455.4
Puerto Rico	22.0	20.9	20.9	21.3		
Rhode Island	10.4	9.9	14.8	15.0	15.4	15.9
South Carolina					19.7	68.1
Vermont	5.3	5.3	8.2	8.4	8.6	9.0
Virgin Islands	0.8	0.9	0.9	1.0	1.1	
West Virginia		8.8	17.6	17.9	18.3	19.0
Wisconsin				26.0	53.1	82.8
Total	484.0	634.0	1,001.0	1,468.0	2,503.0	2,910.0

---

[1] Assumes no change in State unemployment systems.

Source: U.S. Department of Labor, Employment and Training Administration, Division of Acturial Services.

(2) Suspension of fifth year offset credit reduction (sec. 273 of the Act and sec. 3302 of the Code)

Prior Law

A State that has depleted its own unemployment funds may receive Federal loans as necessary to pay regular State benefits and the 50-percent State share of extended benefits. States that borrow funds have 2 to 3 years to repay the loan, depending on the month the loan is received. If a State does not fully repay all loans within the 2 to 3 year period, employers in the State could become subject to an annual reduction in the offset credit against the gross Federal unemployment tax rate of at least 0.3 percent. This means the net Federal tax rate could become subject to annual increases of at least 0.3 percent, up to a maximum of 3.4 percent, until sufficient revenue has been raised through such increases to repay the State's entire outstanding loan balance.

There are two potential credit reductions that are in addition to the annual 0.3 percent reduction. In the third year, in addition to another 0.3 percent reduction, employers in the State face a reduction equal to the amount by which 2.7 percent exceeds the State's average tax rate on taxable wages in the calendar year to which the reduction applies. In the fifth year and thereafter, employers faced a reduction, in addition to another 0.3 percent, equal to the higher of the amount of the additional third year reduction or the amount that the State's 5-year benefit cost rate exceeds the State's average tax rate on taxable wages in the calendar year to which the reduction applies. (The benefit-cost rate is benefits divided by taxable wages.)

Reasons for Change

The Act suspends the additional credit reduction in the fifth year a State has an outstanding debt. The purpose of this provision is to provide fiscal relief to States and employers in those States most heavily impacted by high unemployment rates. For a State that has experienced inordinately high benefit costs due to protracted high unemployment, that extra credit reduction could have meant a very sharp federal tax increase, perhaps to the full limit of the federal tax, 6.2 percent under the Act (3.4 percent under prior law). This fifth year provision, which has never been imposed, was intended to encourage States to impose taxes at levels sufficient to meet their benefit costs. The possibility that States with relatively high tax rates would be affected by this provision because their benefit costs have been affected by a prolonged recession was not anticipated. Now that this appears to be a possibility in one or more States, and because the gross FUTA tax is being almost doubled, it is appropriate to relieve States of the burden of this extra credit reduction, provided they have taken no action to reduce the solvency of their unemployment compensation systems.

Explanation of Provision

The Act drops the additional credit reduction based on the State's previous 5-year benefit cost rate that begins in the fifth year a State is subject to annual reductions in the credit against the gross FUTA because of outstanding Federal unemployment loans. This provision applies to a debtor State in any tax year, beginning after December 31, 1982, in which the State has taken no action during the 12-month period ending on September 30 which has reduced the solvency of the State unemployment trust fund.

Effective Date

The provision is effective for taxable years beginning after December 31, 1982.

(3) Interest on Federal unemployment loans (sec. 274 of the Act and sec. 1202 of the Social Security Act)

Prior Law

Provisions in the Omnibus Budget Reconciliation Act of 1981 modified FUTA provisions regarding Federal unemployment loans to the States. Effective April 1, 1982, through December 31, 1987, States are charged interest on new loans that are not repaid by the end of the fiscal year in which they are obtained. Under law prior to that Act, States could receive these loans interest-free. The interest rate is the same rate as that paid by the Federal Government on State reserves in the Federal Unemployment Trust Fund for the quarter ending on December 31 of the preceding year, but not higher than 10 percent. States may not pay the interest directly or indirectly from State unemployment trust funds.

Reasons for Change

The Department of Labor estimated that at least 21 States will receive Federal unemployment loans in fiscal year 1983. The level of borrowing reflects larger than normal unemployment expenditures as a result of continued high unemployment. States experiencing the highest unemployment generally are unable to pay state unemployment benefits without incurring substantial interest charges. The Act permits a State that has been experiencing a protracted period of high unemployment to postpone interest payments on loans.

Explanation of Provision

Effective for interest due after December 31, 1982, the Act permits States with high unemployment to reduce payments of interest on Federal unemployment loans to 25 percent of the amount due in any year, and thereby extend the payment of the total interest obligation over a 4-year period. (Interest is to be charged on any deferred amount.) A State can extend payment of interest due in any calendar year in which the State insured unemployment rate (the percentage of workers covered by the State's unemployment insurance law who file claims for State benefits) equaled or exceeded 7.5 percent during the first 6 months of the preceding calendar year.

Effective Date

The provision is effective for interest required to be paid after December 31, 1982.

d. Exclusions from Federal unemployment tax

(1) Treatment of certain services performed by students (sec. 276 of the Act and sec. 3306 of the Code)

Prior Law

Under prior law, wages paid to a student under age 22, who was a full-time student enrolled in a work-study or internship program, were excluded from the Federal unemployment tax if the work performed was an integral part of the student's academic program. Wages paid to full-time students employed by summer camps were not excluded from the Federal unemployment tax.

Reason for Change

While the age 22 limitation was sufficient to cover most undergraduate students, it did not cover most graduate-level programs. In addition, school attendance at all educational levels by those over age 22 has grown tremendously in recent years. For example, veterans and others often work for a period of time before engaging in post-high school studies.

Many schools and educational institutions combine outside work experience with formal classroom study. The work portion of these programs is integrated into the regular curriculum and is a required component of the educational program. Congress did not believe that work performed by a student which is a required component of an integrated work-study curriculum involves the kind of employment or the employer-employee relationship that was intended to be covered by the unemployment insurance system. Therefore, the wages paid to these student interns should not be taxable under the Federal unemployment compensation law. Accordingly, Congress found no basis for the age 22 limitation.

Explanation of Provision

The Act exempts from the Federal unemployment tax any wages paid to a student enrolled full-time in a work-study or internship program, regardless of age, for work that is an integral part of the student's academic program, effective for services performed after the date of enactment. In addition, for tax year 1983 only, the Act exempts wages paid by certain summer camps to employees who are full-time students.

Effective Date

The provision related to the age limitation of student interns is effective with respect to services performed after the date of enactment of the Act.

The provision related to students employed by summer camps applies to remuneration paid after December 31, 1982, and before January 1, 1984.

(2) Services of certain alien farmworkers (sec. 277 of the Act and sec. 3306 of the Code)

Prior Law

Federal Unemployment Tax (FUTA) is imposed on farm operators who employ 10 or more agricultural workers in 20 weeks, or have a quarterly payroll for agricultural services of at least $20,000. A temporary provision in Federal law excluded from FUTA wages paid to alien farmworkers admitted to the United States pursuant to sections 214(c) and 101(a)(15)(H)(ii) of the Immigration and Nationality Act. Under prior law, the exemption from FUTA expired on December 31, 1981.

Reason for Change

Sections 214(c) and 101(a)(15)(H) of the Immigration and Nationality Act pertain to residents of foreign countries who do not intend to abandon such residency and who are admitted to the United States to work for a temporary period of time during peak agricultural crop seasons. They are admitted only after the Secretary of Labor has determined and certified to the Secretary of State and to the Attorney General that there are not sufficient workers in the United States who are available to do the specific work the non-resident workers are admitted to perform.

These farm workers return to their countries and, therefore, are not able to collect unemployment compensation to which they might be entitled as a result of their employment in the United States. For this reason it has been argued that farmers should not be required to pay unemployment taxes on wages paid to such workers. Congress, however, remained concerned that a permanent exemption from the Federal unemployment tax might provide incentives for farmers to use these non-resident workers rather than U.S. workers for whom the unemployment tax would be payable. In addition, in light of major immigration and "guestworker" legislative proposals that were pending before Congress, a temporary exclusion was appropriate.

Explanation of Provision

The Act extends for two years—from January 1, 1982, to January 1, 1984—the temporary exclusion in prior law that exempts employers from paying Federal unemployment taxes on wages paid to certain alien farm workers.

Effective Date

The provision applies to services performed after December 31, 1981, and before January 1, 1984.

3. Medicare coverage of, and application of hospital insurance tax to, Federal employment (sec. 278 of the Act, secs. 1402, 3121 and 3122 of the Code, and secs. 210, 226, 226(A) and 1811 of the Social Security Act) *

Prior Law

Entitlement to protection under the hospital insurance (part A) portion of the medicare program for most individuals is linked to entitlement to monthly social security retirement, survivor, or disability benefits or to monthly benefits under the railroad retirement system. This entitlement is earned through work in employment covered by the social security or railroad retirement systems. Workers and employers finance the cost of hospital insurance benefits by payment of the hospital insurance tax. (The tax is imposed on employers and employees each at the rate of 1.3 percent of covered wages received during 1982–1984, 1.35 percent of wages received during 1985, and 1.45 percent of wages received after December 31, 1985.)

Certain kinds of employment are excluded from the social security system. Under prior law, there was an exclusion of Federal civilian employment that is covered under a staff retirement system established by law. Regular Federal employees, including postal workers, are covered under such retirement systems. Consequently they paid no hospital insurance taxes, nor was their Federal employment used in determining entitlement to hospital insurance.

Reasons for Change

A significant proportion (about 80 percent) of Federal employees or retirees have worked long enough (or their spouses have) in employment covered by social security to become insured for medicare hospital insurance protection. However, while most workers in covered social security employment are subject to the hospital insurance tax throughout their entire working careers, Federal employees could earn the same protection with relatively fewer years of work subject to the tax. Congress believed that Federal employees (and the Federal government, as their employer) should bear a more equitable share of the cost of financing the health benefits to which many of them eventually become entitled.

Accordingly, the Act subjects Federal employment to the hospital insurance portion of the FICA tax, effective January 1, 1983, and provides for use of the newly covered employment in determining eligibility for medicare hospital insurance. To minimize the possibility that Federal employees who were subject to the tax might fail to meet the insured status requirements, the Act includes a transitional provision allowing prior Federal service to be credited toward medicare eligibility.

---

* For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 276; S. Rep. No. 97–494, Vol. 1 (July 12, 1982), pp. 378–379; Senate floor amendment, 128 Cong. Rec. S9018 July 22, 1982); and H. Rep. No. 97–760 (August 17, 1982), pp. 657–658 (Joint Explanatory Statement of the Committee of Conference).

Explanation of Provision

All Federal employment formerly excluded from FICA taxes is made subject to the hospital insurance portion of the tax, except for certain services performed by penal inmates, medical interns and student nurses, and temporary emergency employment. Employees of States and localities, including the District of Columbia, continue to be exempt from mandatory coverage.

Individuals who have been Federal employees and who reach age 65, who suffer from end-stage renal disease, or who become disabled will become entitled to medicare hospital insurance after paying hospital insurance taxes for the same number of years (usually 10) that is required of most other workers and after meeting the same requirements applicable to other individuals.

Individuals in Federal employment who perform service during and before January 1983 will be granted credit toward medicare eligibility (up to the minimum amount required) for past Federal employment. The Act permits individuals who have worked for the Federal Government to obtain medicare benefits if they file and meet the insured status and other disability eligibility requirements of the social security disability cash benefits program, even though no such cash benefits are payable. The medicare application is to be treated as an application for disability benefits (for purposes of determining eligibility to medicare). The Act directs the Secretary of Health and Human Services and the Director of the Office of Personnel Management to fully inform Federal employees (particularly those who might be or become eligible for medicare benefits because of a disability) of the terms and conditions of medicare eligibility.

Effective Date

Hospital insurance taxes are imposed on remuneration paid after December 31, 1982.

The transitional provision permitting certain pre-1983 Federal employment to be credited in determining medicare eligibility is applicable to individuals who performed service in Federal employment both during January 1983, and before January 1, 1983.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $617 million in 1983, $837 million in 1984, $927 million in 1985, $1,066 million in 1986, and $1,163 million in 1987. Fiscal year outlays are expected to be reduced by $122 million in 1983, $163 million in 1984, $176 million in 1985, $199 million in 1986, and $213 million in 1987. (Outlay reductions occur because employer FICA contributions from off-budget agencies are treated as offsetting receipts for budget purposes; the outlay reduction figures are net of outlay increases attributable to increased medicare eligibility.)

G. Excise Tax Provisions

1. Airport and Airway Trust Fund taxes and trust fund transfers (secs. 279–281A of the Act and secs. 4041, 4081, 4261, 4271, and 9502 of the Code)*

Prior Law

Overview

The Airport and Airway Revenue Act of 1970 (title II of Public Law 91-258) increased some existing aviation excise taxes, imposed several additional aviation excise taxes, and established the Airport and Airway Trust Fund to receive revenues from these excise taxes. These excise taxes were allowed either to expire or decline on October 1, 1980. The revenues from the aviation-related taxes went into the Airport and Airway Trust Fund for the period July 1, 1970, through September 30, 1980 (the "prior trust fund period").

Air passenger ticket tax

An excise tax of 5 percent of the amount of the fare was imposed on air passenger transportation within the United States from October 1, 1980, through August 31, 1982 (sec. 4261). Revenues from the tax went into the general fund. During the prior trust fund period, the tax was 8 percent, and the revenues were deposited in the Airport and Airway Trust Fund.

Air transportation between the United States and a foreign location which is not more than 225 miles from the nearest point in the continental United States (defined as only within Canada and Mexico), as well as between two such foreign locations, generally is subject to the air passenger tax, if payment for the travel is made in the United States. This tax does not apply to transportation between the United States and other foreign locations where payment is made outside the United States. It also does not apply to the U.S. portions of certain uninterrupted international air transportation. Further, the air passenger tax does not apply to the international portion of flights to or from the continental United States or between Alaska and Hawaii.

International departure tax

During the prior trust fund period, a $3 per passenger departure tax applied to international air transportation that began in the United States and was an uninterrupted flight that terminated outside the United States and beyond the 225-mile zone in Canada and

---

*For legislative background of the provisions, see: H.R. 4961, as reported by the Senate Finance Committee, secs. 281–283; S. Rep. No. 97–494, Vol. 1 (July 12, 1982), pp. 380–387; Senate floor amendments, 128 Cong. Rec. S8815–8816 (July 21, 1982); H. Rep. No. 97–760 (August 17, 1982), pp. 659–661 (Joint Explanatory Statement of the Committee of Conference); and H. Con. Res. 398, 128 Cong. Rec. H6636 (August 19, 1982).

Mexico (sec. 4261(c)). An uninterrupted international flight could have had a domestic stopover of not more than 6 hours without being subject to the domestic ticket tax. The tax also applied to flights between the continental U.S. and Alaska or Hawaii or between Alaska and Hawaii. The tax expired on October 1, 1980.

Air freight waybill tax

The 1970 Act imposed a tax of 5 percent of air freight waybill charges (sec. 4271); this tax expired on October 1, 1980. In determining taxable transportation, the same rules generally applied as for transportation of persons, except that the air freight tax applied (and currently applies) only to amounts paid for transportation of property by air beginning and ending in the United States. Also, the air freight tax did not (and currently does not) apply to the international portion of flights from the continental United States to or from Alaska or Hawaii or between Alaska and Hawaii.

Other aviation excise taxes

During the prior trust fund period, there was a 7-cents-per-gallon tax on gasoline, jet and other aviation fuels taxes used by noncommercial (general) aviation (sec. 4041(c)). The tax on aviation gasoline was allowed to decline to 4 cents per gallon on October 1, 1980, i.e., the rate for the manufacturers tax on gasoline generally. The 7-cents-per-gallon tax on nongasoline aviation fuels (chiefly jet fuels) was allowed to expire on the same date. Fuels used by commercial aviation were (and are) exempt from the aviation fuels taxes because passengers and freight were (and are) taxed by the ticket and waybill taxes.

An aircraft use tax was in effect during the prior trust fund period. The tax involved (1) a $25 per plane annual tax, plus (2) a weight tax of 3½ cents per pound for turbine-powered (jet) aircraft and 2 cents per pound for nonturbine powered aircraft for each pound in excess of 2,500 pounds of maximum certificated takeoff weight.

Excise taxes also applied to aircraft tires and tubes (and continue to apply through December 31, 1983; see footnote 1, below). Aircraft tires were taxed as non-highway tires at the rate of 5 cents per pound, and all inner tubes were taxed at 10 cents per pound (sec. 4071). The revenues from these taxes were transferred from the Highway Trust Fund to the Airport and Airway Trust Fund during the prior trust fund period. After September 30, 1980, and through August 31, 1982, these taxes were again deposited in the Highway Trust Fund. The tax rate on nonhighway tires became 4.875 cents per pound on January 1, 1981.

Exemptions

Exemptions from the air passenger tax and the waybill tax were (and are) provided for transportation by small aircraft on nonestablished lines (sec. 4281) and for private air transportation services provided within a group of affiliated corporations (sec. 4282). Aircraft not subject to the passenger or freight taxes were (and are) subject to the applicable fuels tax.

There also was (and is) a general exemption (or a refund or credit) from the aviation fuels taxes for fuel sold for use (or used) on a farm for farming purposes. The taxes on aviation fuels did not (and currently does not) apply to aircraft owned by a tax-exempt aircraft museum operated exclusively for the procurement, care, and exhibition of World War II aircraft. Further, there were (and are) general exemptions from the fuels taxes for fuels sold for use (or used) by a State or local government, by a nonprofit educational organization, and for exported fuels.

Trust fund authorization purposes

The Airport and Airway Trust Fund was established as of July 1, 1970. Transfer of aviation-related excise tax revenues into the Trust Fund was authorized in that Act and was terminated as of October 1, 1980.

The 1970 Act provided that the aviation excise taxes deposited into the Trust Fund and the interest earned on the deposits were to be available to meet specified airport and airway obligations of the United States incurred under Title I of the 1970 Act, as it was in effect on the date of enactment. As a result, subsequent expansion of trust fund budget authority required corresponding amendments to the trust fund statute.

The following outline presents a summary listing of the Airport and Airway Trust Fund expenditure programs authorized under the 1970 Act as amended.

a. *Airport Development Aid Program (ADAP).—*

(1) *Airport planning.*—Grants to planning agencies for airport system planning and public agencies for airport master planning; airport noise compatibility planning grants for air carrier airports eligible for terminal development costs.

(2) *Airport development projects:*

(a) Airport construction.—Construction, improvement or repair of a public airport.

(b) Airport terminal facilities.—Nonrevenue-producing public use areas which are directly related to movement of passengers and baggage at air carrier airports, which have the required safety and security equipment; does not include costs of constructing public auto parking facilities or costs to construct, alter, or repair a hangar or any airport building unless used to house facilities or activities directly related to safety of persons at the airport; authorized uses of funds also include multimodal terminal development and bond retirement for certain airports.

(c) Land acquisition.—Includes land or property interests for airport noise control purposes.

(d) Airport-related equipment.—Airport security equipment required by Department of Transportation regulations, snow removal equipment, noise suppressing equipment, navigation aids, and safety equipment required for airport certification.

(e) Airport noise compatibility programs.—Includes soundproofing of public buildings; local governmental units are eligible for project grants as well as airports.

b. *Facilities and Equipment Program (F&E).*—Costs of acquiring. establishing, and improving air navigation facilities.

c. *Research, Engineering, Development, and Demonstration Program (R.E. & D.).*—Projects in connection with Federal Aviation Administration research and development activities.

d. *Operations and Maintenance Programs (O&M).*—Flight checking and maintenance of air navigation facilities; services provided under international agreements relating to the U.S. share of joint provision of air navigation services.

e. *Other costs.*—Certain airline costs of international passenger security screening facilities and related services.

Reasons for Change

Congress determined that the needs of the air transportation system required additional revenues and that resumption of funding of the Airport and Airway Trust Fund with increased aviation excise tax revenues was the most appropriate manner in which to insure that sufficient funds would be available. Therefore, Congress believed that the excise taxes on air passengers and air freight should be increased to or reimposed at their prior trust fund period levels and the revenues from those taxes again transferred to the Trust Fund.

Congress further concluded that noncommercial (general) aviation makes significant use of the airport and air navigation systems financed by the aviation excise taxes, and therefore it should pay a greater share of the system's costs for such use. Congress also believed that the prior law aircraft use tax should not be reenacted. Therefore, the aviation fuels taxes were increased above their prior trust fund period levels. In addition, Congress determined that the excise tax on aircraft tires and tubes should again be transferred to the Airport and Airway Trust Fund.[1]

Congress estimated that this level of aviation excise taxes will provide funds for necessary future trust fund expenditures to finance a modernized, expanding air transportation system.

In addition, Congress determined that, in light of the user fee concept of these taxes, certain helicopters used in timber and hard mineral resource operations that do not use Federally-financed airports or airway system facilities should be exempt from the taxes on aviation fuels and the air passenger ticket tax.

Explanation of Provisions

Tax rates

Under the Act, the air passenger ticket tax is restored to the prior 8-percent rate; the air freight waybill tax is reimposed at a 5-percent rate; and the international departure ticket tax is reimposed at a $3-per-passenger rate. In addition, the tax on noncommercial aircraft gasoline fuels is increased to 12 cents per gallon and a 14-cents-per-gallon tax is imposed on noncommercial nongasoline fuels (e.g., kerosene for jet aircraft).

The increased and reimposed aviation excise taxes will terminate after December 31, 1987.

---

[1] Under Title V (sec. 514) of the Surface Transportation Assistance Act of 1982 (H.R. 6211, P.L. 97-424), the excise taxes on nonhighway tires (including aircraft tires) and the excise tax on all inner tubes are scheduled to be repealed on January 1, 1984.

The aircraft use tax that was in effect during the prior trust fund period was not reenacted.

The Act also made three other modifications to the application of the air passenger ticket tax:

(1) The 6-hour layover rule has been increased to 12 hours for purposes of determining whether the flight is treated as uninterrupted international travel subject only to the departure tax (i.e., not subject to the domestic ticket tax).

(2) The Secretary of the Treasury has been granted the authority to waive the 225-mile zone rule if Canada or Mexico enters into a "qualified agreement" regarding the tax to be applied to persons traveling by air between the United States and that country with the objective of eliminating double taxation of travel between the countries or within the 225-mile zone.

(3) The requirement that the ticket fare and tax be shown by trip segments has been repealed, effective from the date of enactment. The requirement for separately showing the total airfare and total ticket tax is retained.

Exemption for certain helicopter uses

The Act also provides an exemption (via a refund or credit) for fuels used in helicopters when the helicopters are used for certain qualified purposes, and if the helicopter does not (1) take off from or land at a facility eligible for assistance under the Airport and Airway Development Act of 1970, as amended, or (2) otherwise use Federal airway system facilities or services. In addition, no tax will be collected with respect to passengers who are transported by helicopters on these exempt flights.

Specifically, the taxes will not be imposed when the helicopter is used for (1) transporting individuals, equipment or supplies in the exploration for, or the development or removal of, hard mineral resources, or (2) the planting, cultivation, cutting, or transportation of, or caring for, trees (including logging operations). The forestry exemption covers fuels used in tree farming and timber harvesting activities. This is intended to include, for example, fuels used by helicopters engaged in fire control or insect control of trees, as well as in tree cultivation and logging operations.

The exemption from the fuels tax provided by this provision applies only to fuels used in the qualifying activities. If fuel is delivered into the fuel supply tank of a qualified helicopter and such fuel is used partly for qualified purposes and partly for nonqualified purposes, the tax will apply to that portion of the fuel which is used for the nonqualified purposes. In addition, the Act provides that the rules and regulations under sections 4041 and 6427 will govern the application of these exemptions. Thus, existing registration, refund, and credit procedures will apply.

Other exemptions

The other exemptions from the aviation excise taxes under prior law continue under the Act.

Extension of trust fund provisions and transfers to the fund

The Act provides authority for expenditures from the Airport and Airway Trust Fund through September 30, 1987, and again transfers aviation excise tax receipts to the Trust Fund. Receipts from the aviation excise taxes extended or reinstated under the Act, and revenues from the taxes on aircraft tires and tubes (which were deposited in the Highway Trust Fund for the period October 1, 1980, through August 31, 1982) are to be transferred to the Trust Fund for the period September 1, 1982 through December 31, 1987.[2] These monies and the interest earned thereon will be available to fund the airport and airway programs under the authorization Acts indicated below.

Trust fund expenditure purposes

Expenditures from the Trust Fund may be made, as provided by appropriation Acts, to satisfy obligations incurred under title I of the Airport and Airway Development Act of 1970, the Airport and Airway Development Act Amendments of 1976, the Aviation Safety and Noise Abatement Act of 1979, the Fiscal Year 1981 Airport Development Authorization Act, or under the provisions of the Airport and Airway Improvement Act of 1982 (as such Acts were in effect on the date of enactment of the 1982 Act--title V of P.L. 97-248)

Expenditures also may be made to meet obligations incurred under the Federal Aviation Act of 1958, as amended, which are attributable to planning, research and development, construction or operation and maintenance of (1) air traffic control, (2) air navigation, (3) communications, or (4) supporting services for the airway system. In addition, expenditures may be made for the portions of the administrative expenses of the Department of Transportation that are attributable to the activities described in this paragraph.

Transfer of trust fund provisions to the Internal Revenue Code

Under the Act, as of September 1, 1982, provisions which establish the Airport and Airway Trust Fund and relate to its management, and provisions by which amounts appropriated to the Trust Fund are transferred from the general fund of the Treasury, become provisions the Internal Revenue Code of 1954. The Airport and Airway Trust Fund as transferred to the Code will be treated for all purposes of law as the continuation of the Airport and Airway Trust Fund established by Title II of Public Law 91-258.

The Act standardizes and updates provisions of the Airport and Airway Trust Fund to conform to the language of other trust funds. Congress intends no other substantive effect in deleting archaic language in the prior trust fund statute.

Effective Dates

The amendments to the air passenger, freight waybill, and international departure taxes apply to transportation beginning after August 31, 1982, but only with respect to amounts paid after that date for such transportation. Thus, for example, if a domestic passenger ticket for transportation on September 30, 1982, were purchased on August 15, 1982, the 5-percent tax rate would apply rather than the 8-percent rate. Likewise, in the case of a contract for providing taxable transportation over a period of time which was entered into before September 1, 1982, but under which payments were to be made on both sides of the effective date of the tax increases, the higher tax rates would apply to payments made after August 31, 1982, for transportation beginning after that date. The lower tax rate would be applicable to transportation before September 1, 1982, and to amounts paid under the contract before that date. The amended taxes do not apply to transportation beginning after December 31, 1987.

---

[2] For scheduled repeal of the excise taxes on aircraft tires and tubes, see footnote 1, *supra*.

The amendments to the fuels taxes apply with respect to fuels sold in a taxable sale after August 31, 1982, and before January 1, 1988.

The trust fund provisions were effective on September 1, 1982.

Revenue Effect

These changes are expected to increase fiscal year net budget receipts by $817 million in 1983, $962 million in 1984, $1,089 million in 1985, $1,216 million in 1986, and $ 1,357 million in 1987. (See footnote 4 to Table V-3 for estimated gross increase in fiscal year aviation excise tax receipts.)

2. Temporary increase of excise tax on communication services (sec. 282 of the Act and sec. 4251 of the Code) *

Prior Law

Prior law imposed (through 1984) a 1-percent excise tax on amounts paid for local telephone service, toll (i.e., long distance) telephone service and teletypewriter exchange service (sec. 4251). The tax is paid by the person who pays for service to the person rendering the service, who in turn remits the tax for deposit in the general fund of the Treasury.

Exemptions from the tax are provided for communications services furnished to news services (except local telephone service to news services), international organizations, the American National Red Cross, servicemen in combat zones, nonprofit hospitals and educational organizations, and State and local governments. Other exemptions include amounts paid for installation charges and for certain calls from coin-operated telephones (sec. 4253).

Reasons for Change

Congress decided that the broad-based increase in revenues required by the fiscal outlook through 1985 also mandated an increase in and extension of the telephone excise tax. The prior law termination date was extended only 1 year because Congress believed that fiscal prospects after 1985 warranted allowing the tax to expire.

Explanation of Provision

The Act increases the telephone excise tax to 3 percent for calendar years 1983–1985, and terminates the tax after 1985.

Effective Date

The 3-percent tax rate applies to amounts paid pursuant to bills rendered after December 31, 1982, and before January 1, 1986.

Revenue Effect

This provision is expected to increase net fiscal year budget receipts by $616 million in 1983, $1,073 million in 1984, $1,600 million in 1985, and $730 million in 1986. (See footnote 5 of Table V–3 for estimated gross increase in fiscal year telephone excise tax receipts.)

---

* For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 284; S. Rep. No. 97–494, Vol. 1 (July 12, 1982), pp. 388–389; and H. Rep. No. 97-760 (August 17, 1982), p. 663 (Joint Explanatory Statement of the Committee of Conference).

3. Temporary increase in cigarette excise taxes (sec. 283 of the Act and sec. 5701 of the Code)*

Prior Law

Excise taxes are imposed on cigarettes manufactured in or imported into the United States (sec. 5701). In general, the manufacturer or importer is liable for these taxes (sec. 5703), which are determined when the products are removed from the factory or released from customs custody (i.e., upon removal from bonded premises).

Under prior law, the rate of tax on small cigarettes (those which weigh no more than 3 pounds per thousand) was $4 per thousand, which was equal to 8 cents per pack of 20 cigarettes. Generally, the rate of tax on large cigarettes (those which weigh more than 3 pounds per thousand) was $8.40 per thousand, except that higher rates applied to large cigarettes that exceeded 6.5 inches in length.

Reasons for Change

The prior law cigarette excise tax rates had not been increased since 1951. Since the tax is imposed as a set amount, rather than as a percentage of sales price, the effective level of the tax had declined by more than 70 percent in constant dollars since it was last amended. Congress believed, therefore, that an adjustment to the tax was appropriate. Doubling the tax rate, as was done under the Act, does not increase the per-pack tax, in real terms, above the 1951 level.

Also, Congress determined that the broad-based increase in revenues required by the fiscal outlook through 1985 mandated an increase in the cigarette excise taxes through fiscal year 1985.

Explanation of Provision

Tax rates

The Act increases the rate of tax on small cigarettes to $8.00 per thousand, which is equal to a tax rate of 16 cents per pack. The rate of tax on large cigarettes, less than 6.5 inches in length, is increased to $16.80 per thousand The rate of tax on large cigarettes in excess of 6.5 inches in length is correspondingly increased.

---

*For legislative background of the provision, see H.R. 4961, as reported by the Senate Finance Committee, sec. 285; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 390-391; Senate floor amendments, 128 Cong. Rec., S8888-8895 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), p. 662 (Joint Explanatory Statement of the Committee of Conference).

Also, see H.R. 6056, Technical Corrections Act of 1982, as reported by the Senate Finance Committee, sec. 306, S. Rep. No. 97-592 (Sept. 27, 1982), p. 53; Senate floor amendments, 128 Cong. Rec. S12737-S12738; and Conference Report, sec. 306(a)(14), H. Rep. No. 97-986 (Dec. 21, 1982), p. 11.

Floor stocks tax

The Act also includes provisions extending the doubled rates of the cigarette excise taxes to certain cigarette floor stocks. Under the Act, an additional tax is imposed on each person holding cigarettes for sale (other than certain retail stocks) on January 1, 1983, which cigarettes were removed from bonded premises before that date and a tax paid on removal at the pre-1983 rates. The additional tax is equal to the excess of the tax that would apply to removal of the cigarettes from bonded premises on or after January 1, 1983, over the tax that was previously collected on such cigarettes. This additional tax is due on February 17, 1983.[1]

An exemption from the floor stocks tax is provided for certain cigarettes held for sale by retailers; this exemption applies only to cigarettes held at the retail location where they are normally sold to consumers. For example, cigarettes held for sale on the shelves of a retail store will be exempt as held by a retailer, but cigarettes held in warehouses or other similar facilities where retail consumers do not have regular access to them are not to be treated as retail stocks held by a retailer.

Effective Date

This provision applies to cigarettes removed from bonded premises after December 31, 1982, and before October 1, 1985, and to floor stocks (other than certain retail stocks held by a retailer) held on January 1, 1983.

Revenue Effect

This provision is expected to increase net fiscal year budget receipts by $1,275 million in 1983, $1,829 million in 1984, and $1,859 million in 1985. (See footnote 6 of Table V-3 for estimated gross increase in fiscal year cigarette excise tax receipts.)

---

[1] Section 306(a)(14) of the Technical Corrections Act of 1982 (P.L. 97-448) extended the date from January 18, 1983 (as included in TEFRA), to February 17, 1983. This extension of time was intended to be in lieu of the discretionary extension authority as stated in the conference report on TEFRA (H. Rep. No. 97-760, at p. 662). Under that conference report statement, Congress intended that, in order to prevent financial hardship from payment of the entire floor stocks tax on or before January 18, 1983, the Treasury Department exercise its present authority over establishment of the time and method for paying cigarette excise taxes to permit extensions of time of up to 30 days for payment of the floor stocks tax in circumstances where the taxpayer demonstrates that financial hardship would result from payment of the tax on the date otherwise prescribed.

4. Windfall profit tax provisions

a. Elimination of the TAPS adjustment (sec. 284 of the Act and sec. 4996 of the Code) *

Prior Law

The windfall profit tax is an excise tax imposed on the windfall profit element of the price of domestically produced crude oil at the time taxable crude oil is removed from the premises from which it was produced. The tax is a percentage, ranging up to 70 percent, of the windfall profit earned on any barrel of taxable crude oil, but not in excess of 90 percent of the net income allocable to such barrel. The windfall profit generally equals the difference between the removal price of the oil and an adjusted base price, reduced by an adjustment for State severance taxes. The term taxable crude oil includes Sadlerochit oil, which is crude oil produced from the Sadlerochit Reservoir in the Prudhoe Bay oil field. Most Sadlerochit oil is transported to the lower 48 states by way of oil tankers and the Trans-Alaska Pipeline System (TAPS).

Sadlerochit oil is taxable in tier one at a rate of 70 percent. The adjusted base price of such oil is, therefore, the controlled price which would have applied to such oil under the March 1979 energy regulations if it had been produced and sold in May 1979 as upper tier oil, reduced by $0.21, increased by an inflation adjustment. The removal price for any barrel of Sadlerochit oil removed during any calendar month shall be the average of the producer's removal prices for such month.

Under prior law. Sadlerochit oil was subject to a special adjustment to its adjusted base price. Under this adjustment, the producer was allowed to increase the oil's adjusted base price for any quarter by the TAPS adjustment for that quarter, if any. The TAPS adjustment was the excess of $6.26 (the average cost of transporting a barrel of Sadlerochit crude oil through the TAPS in 1979) over the average per barrel tariff charged for transporting Sadlerochit oil through the TAPS in the preceding quarter.

The effect of this adjustment was to assure that downward adjustments in the TAPS tariff, which is subject to the jurisdiction of the Federal Energy Regulatory Commission (FERC), did not result in increased windfall profit taxes on Sadlerochit oil. If the TAPS tariff fell, the removal price rose by an equal amount because the wellhead value of the oil will generally equal its value at the refinery minus the costs of transporting the oil from the wellhead to the refinery. The TAPS adjustment assured an equal, and offsetting, increase in the oil's adjusted base price.

---

* For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 287; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 396-397; and H. Rep. No. 97-760 (August 17, 1982), pp. 663 (Joint Explanatory Statement of the Committee of Conference).

There was no adjustment under prior law for any upward adjustment in the TAPS tariff. If, therefore, the TAPS tariff rose above $6.26, thereby decreasing the deemed removal price (and windfall profit tax), no adjustment would follow.

Reasons for Change

The TAPS adjustment provided producers of Sadlerochit oil with a benefit given to no other oil producers under the windfall profit tax. Congress believed that this can no longer be justified at a time of budgetary stringency.

Explanation of Provision

The Act repeals the TAPS adjustment for Sadlerochit oil.

Effective Date

This provision is effective for oil removed after December 31, 1982.

Revenue Effect

The net revenue gain is expected to be $90 million in fiscal year 1983, $145 million in 1984, $154 million in 1985, $142 million in 1986, and $128 million in 1987. (See footnote 7 in Table V-3 for estimated gross increase in fiscal year receipts.)

b. Windfall profit tax on Alaska Native Corporations (sec. 291 of the Act and sec. 4994 of the Code) *

Prior Law

Certain domestic crude oil produced by native corporations "organized under" the Alaska Native Claims Settlement Act (as in effect on January 21, 1980, ANCSA) is exempt from the windfall profit tax.

Reasons for Change

The Congress wished to clarify that qualified production could be in a 100-percent owned subsidiary of an ANCSA corporation.

Explanation of Provision

The Act clarifies the Indian oil exemption by providing that certain domestic crude oil, the producer of which is a corporation "organized pursuant to" the Alaska Native Claims Settlement Act (including a wholly owned subsidiary) is exempt Indian oil within the meaning of the windfall profit tax.

Effective Date

This provision is effective on or after September 4, 1982.

---

* For legislative background of the provision, see: Senate floor amendments, 128 Cong. Rec. S 8904 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 664 (Joint Explanatory Statement of the Committee of Conference).

5. Additional refunds relating to repeal of excise tax on buses (sec. 274 of the Act and sec. 231(c) of the Energy Tax Act of 1978)*

Prior Law

Before enactment of the Energy Tax Act of 1978, a 10-percent manufacturers excise tax was imposed on buses sold by a manufacturer, a producer, or an importer. The Energy Tax Act repealed that manufacturers excise tax on buses sold after November 9, 1978.

The Energy Tax Act also contained provisions which effectively allowed, under certain conditions, exemption from the excise tax for buses sold to ultimate purchasers after April 19, 1977, and before November 10, 1978. Under these provisions, a manufacturer, a producer, or an importer was allowed a credit or refund (without interest) for the excise tax paid if—

(1) the manufacturer, etc. possessed evidence of sale to the ultimate purchaser and of reimbursement of tax to that purchaser;

(2) the manufacturer, etc. filed a claim for credit or refund with the Treasury Department before September 5, 1979; and

(3) the manufacturer, etc. reimbursed the ultimate purchaser for the tax paid on qualified sales of buses before September 5, 1979.

Reasons for Change

The intent of the requirement of prior law that customers be reimbursed for tax paid before the manufacturer or importer received a refund of excise tax on buses was to insure that the benefit of the refund would accrue to the person who actually bore the burden of the tax. Congress understood that at least one importer, because of financial hardship, was unable to comply with the prior law requirement that ultimate purchasers be reimbursed before the importer received a refund of excise tax from the Federal Government. Congress believed that any manufacturer or importer that complied with all other requirements for receiving a refund should be allowed to reimburse its customers simultaneous with receipt of its refund from the Government, since the intent of the requirement is still satisfied under such circumstances.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the House Committee on Ways and Means, sec. 107; H. Rep. No. 97-404 Dec. 14, 1981, pp. 25-26; and H. Rep. No. 97-760 (August 17, 1982), p. 688 (Joint Explanatory Statement of the Committee of Conference).

Explanation of Provision

In general, the Act changes section 231(c) of the Energy Tax Act of 1978 to broaden the conditions under which a manufacturer, a producer, or an importer is eligible for a credit or refund of the manufacturers excise tax paid on buses that were sold to ultimate purchasers after April 19, 1977, and before November 10, 1978. Under the Act, the date before which the ultimate purchasers must have been reimbursed is extended from September 5, 1979, to January 1, 1983. The Act does not, however, change the requirement of prior law that a manufacturer, etc. must have filed a claim for credit or refund with the Treasury before September 5, 1979.

In addition, the Act relaxes the prior law requirement that the manufacturer, etc. possess evidence of reimbursement of the tax to the ultimate purchaser. Under the Act, the manufacturer, etc. may make reimbursement at the same time it receives the refund. Such simultaneous reimbursement must occur under an arrangement, such as an escrow, satisfactory to the Treasury Department.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

It is estimated that this provision will have a negligible effect on fiscal year budget receipts of 1983 and 1984.

H. Miscellaneous Provisions

1. Exclusion from income of National Research Service Awards (sec. 285 of the Act and sec. 161(b)(2) of the Revenue Act of 1978)*

Prior Law

Subject to several limitations, gross income does not include amounts received as a scholarship at an educational institution or as a fellowship grant (sec. 117). In general, amounts received from scholarships or fellowship grants are not excludable from gross income if they constitute compensation for past, present, or future services for the grantor. However, amounts received under Federal programs that are used for qualified tuition and related expenses are not disqualified from the exclusion merely because the individual recipients agree to perform future services as Federal employees.

The amount excludable as a scholarship or fellowship varies depending on whether the individual recipient is or is not a candidate for a degree. In general, a degree candidate may exclude the entire amount of the scholarship or fellowship grant, unless any portion of the award is regarded to be payment for services in the nature of part-time employment. An individual who is not a candidate for a degree is limited to an exclusion of $300 per month for a period of 36 months.

In 1977, the Internal Revenue Service ruled that awards made under the provisions of the National Research Service Awards Act of 1974 to individuals who, in return for receiving the awards, must subsequently engage in health research or teaching or some equivalent service and must allow the Government to make royalty-free use of any copyrighted materials produced as a result of the research are not excludable scholarships or fellowship grants.[1]

The Revenue Act of 1978 provided that amounts received as National Research Service Awards would be treated as excludable scholarships or fellowship grants under section 117. This provision was effective for awards made during calendar years 1974 through 1979. This treatment was extended to awards made in 1980 by Public Law 96-167 and to awards made in 1981 by Public Law 96-541, pending further study.

Reasons for Change

On three separate occasions, Congress has provided on a temporary basis that National Research Service Awards should be treated as excludable scholarships or fellowship grants. Congress continued to believe that consideration should be given to a permanent rule regarding the Federal income tax treatment of National Research Service Awards. However, Congress has not yet been able to devote sufficient time to study this problem adequately. Accordingly, Congress decided to extend the tax-exempt treatment of National Research Service Awards, pending further study.

---

*For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 291; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 398-399; and H. Rep. No. 97-760 (August 17, 1982), p. 666 (Joint Explanatory Statement of the Committee of Conference).

[1] Rev. Rul. 77-319, 1977-2 C.B. 48.

Explanation of Provision

The Act extends for two additional years (to awards made through the end of 1983) the exclusion for National Research Service Awards.

Effective Date

The provision applies to awards made in 1982 and 1983.

Revenue Effect

This provision is expected to reduce fiscal year budget receipts by $8 million in 1983, $7 million in 1984, $4 million in 1985, and $2 million in 1986.

2. Annual accrual accounting method for corporate joint ventures of sugar producers (sec. 230 of the Act and sec. 447(g) of the Code.)*

Prior Law

Under present law, the taxable income from farming of a corporation (or a partnership of which a corporation is a partner) generally must be computed using the accrual method of accounting with the capitalization of preproductive period expenses (sec. 447(a)). Preproductive period expenses are expenses (other than interest, taxes, or losses from casualty, drought, or disease) attributable to property having a crop or a yield that are incurred during the preproductive period of such property. The preproductive period for property is generally the period before the disposition of the property or the disposition of the first marketable crop or yield from the property.

This requirement, however, does not apply to subchapter S corporations, certain family corporations, or small corporations that meet a gross receipts test. Such corporations, and partnerships which have no other type of corporation as a partner, may use the cash method of accounting and may deduct preproductive period expenses when they are paid. The requirement to use the accrual method with the capitalization of preproductive period expenses also does not apply to the business of operating a nursery or a sod farm or the business of forestry or the growing of timber.

A special rule provides that certain corporations may use the "annual" accrual method of accounting (sec. 447(g)). Under the annual accrual method of accounting, preproductive period expenses are not capitalized, but are deducted currently. Corporations that qualify for this special rule are corporations that raise crops (such as sugar cane) which are harvested not less than 12 months after planting. In addition, the corporation must have used the annual accrual method for the 10-year period ending with its first taxable year beginning after 1975, and must have continued to use such method for each taxable year after its first taxable year beginning after 1975.

In the case of a corporation that acquired substantially all the assets of a farming trade or business from another corporation in a transaction in which neither corporation recognized any gain or loss, the acquiring corporation is treated as having used the annual accrual method for the period such method was used by the predecessor corporation to compute the taxable income from the acquired farming business.

---

*For legislative background of the provisions, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 232; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 204-206; and H. Rep. No. 97-760 (August 17, 1982), pp. 666-667 (Joint Explanatory Statement of the Committee of Conference).

Reasons for Change

Congress believed that the prior law relating to corporations which are permitted to use the annual accrual method unfairly discriminated against certain corporate joint ventures that grow sugar cane. Under prior law, if a corporation was permitted to use the annual accrual method for a farming business, a corporation that acquired the business in a tax-free reorganization was also permitted to use the annual accrual method for the business. A partnership, however, that acquired such a business in a similar tax-free transaction was not permitted to use the annual accrual method if any of the partners is a corporation. Congress believed that a partnership that engages in the business of growing sugar cane and each of the partners of which is a corporation that engages in the business of growing sugar cane, other than a subchapter S corporation or personal holding company, should be treated the same as a corporation. Thus, if the annual accrual method is used by a corporation for the business of growing sugar cane and the business is contributed to such a partnership in exchange for an interest in the partnership, the partnership should be allowed to continue to use the annual accrual method for the business.

Explanation of Provision

Under the Act, a "qualified partnership" generally will be treated the same as a corporation for purposes of the annual accrual accounting rules of section 447(g). Under the Act, a qualified partnership must be engaged in the trade or business of growing sugar cane and substantially all of the partnership activities must involve the growing of sugar cane. In addition, each partner must be a corporation, other than a subchapter S corporation or a personal holding company, engaged in the trade or business of growing sugar cane. Growing sugar cane, however, does not have to be the principal activity of each of the partners. The qualified partnership would have to meet the same general requirements that apply to corporations under present law. Thus, for example, the qualified partnership would have to be engaged in a farming business in which crops are raised that are harvested not less than 12 months after planting.

The qualified partnership would also have to meet the requirement relating to continuous use of the annual accrual method. For this purpose, the bill provides a special rule analogous to the rule for transfers of a farming business from one corporation to another corporation. Under the special rule, if a partner of a qualified partnership has contributed a farming business to the partnership in exchange for a partnership interest, the qualified partnership would be treated as having used the annual accrual method for any period the contributing partner had used such method to compute its taxable income from the business.

Thus, for example, if a corporation that is permitted to use the annual accrual method with respect to a sugar cane growing business contributes substantially all of the assets of the business to a qualified partnership in exchange for an interest in the partnership, the qualified partnership would be permitted to use the annual accrual method to compute the taxable income from the business.

Effective Date

The provision applies to taxable years beginning after December 31, 1981.

Revenue Effect

The provision is estimated to have no effect on budget receipts.

3. Certain payments to foreign government officials or employees (sec. 288 of the Act and secs. 162, 954, and 964 of the Code) *

Prior Law

No deduction was allowed for payments to foreign government employees or officials if such payments would have been illegal under any of the Federal laws of the United States, if the laws of the United States had been applicable to the transaction (sec. 162(c)(1)). Since Federal law makes illegal virtually any payment to government officials or employees in return for favorable business dealings, this provision covered most conceivable situations where foreign bribes, kickbacks or similar payments were made.

Payments by a foreign corporation controlled by U.S. shareholders that would not have been deductible under the illegality test of section 162(c) if made by a U.S. person constituted income to the U.S. shareholders under the subpart F provisions of the Code. Such payments did not reduce the controlled corporation's earnings and profits. In addition, payments non-deductible under this illegality test constituted a deemed distribution to shareholders of a Domestic International Sales Corporation ("DISC"), and thus reduced the tax deferral benefits of a DISC. Prior law thus attempted to prevent any reduction in tax arising from the payment of foreign bribes.

In a further attempt to curtail foreign bribes by U.S. businessmen Congress enacted the Foreign Corrupt Practices Act of 1977 ("FCPA"). In general, this Act makes it illegal for U.S. persons or their agents to make, offer, or authorize, either directly or indirectly, payments to foreign government officials, foreign political parties, or foreign political candidates with the intent of influencing official action in order to obtain business. Violations of FCPA can result in fines of up to $1 million for corporations and $10,000 for individuals, and imprisonment for up to five years.

Reasons for Change

Congress believed that a single standard of legality for payments to foreign government personnel is appropriate for both the Foreign Corrupt Practices Act and the Internal Revenue Code. In some cases, the prior tax law test may have been overly harsh. Moreover, the prior tax law test, which required a hypothetical determination of U.S. law, may have needed clarification.

---

* For legislative background of the provision, see: H.R. 4961, as reported by the Senate Finance Committee, sec. 294; S. Rep. No. 97-494 (vol. 1) (July 12, 1982), pp. 164-165; and H. Rep. No. 97-760 (August 17, 1982), p. 669.

Explanation of Provision

The Act amends the provision disallowing a deduction for payments to foreign officals that would be illegal under Federal law if Federal law applied to the transaction to disallow a deduction only where the payment is in violation of the Foreign Corrupt Practices Act. This change limits the applicability of Code section 162(c)(1) since more transactions are made illegal by the Federal laws of the United States than are made illegal under the Foreign Corrupt Practices Act. Because nondeductibility of a payment depends upon the definition of an illegal payment under the FCPA, the disallowance standard will change with any future amendments of the FCPA.

There are two principal types of payments that are allowed as a deduction under the Act that were not deductible under prior law. The first are facilitating payments. These are payments made to government officials to facilitate routine administrative actions that are nondiscretionary on their part. Thus, payments to a customs official to expedite goods through customs are allowed as a deductible payment under the Act.

The second type of payment that is deductible under the Act is one that is a legal payment under the local law of the foreign jurisdiction but which would violate a Federal law other than the Foreign Corrupt Practices Act.

The amendment to the deductibility rule of section 162(c) similarly changes the test for denial of DISC deferral. The Act also conforms the tests for inclusion as Subpart F income and denial of reductions in earnings and profits to the new test for deductibility under section 162(c).

Effective Date

This provision is effective for payments made after the date of enactment, September 3, 1982.

Revenue Effect

It is estimated that this provision will decrease fiscal year budget receipts by $30 million annually during the period 1983–87.

4. Debt management provisions (sec. 289 of the Act and secs. 752 and 757 of the Second Liberty Bond Act)*

a. Rate of interest payable on U.S. savings bonds

Prior Law

The Secretary of the Treasury had discretionary authority to set the rate of interest on savings bonds within certain statutory limits. The Secretary, with the approval of the President, could increase the investment yield on any U.S. savings bond above the current rate in any six-month period by no more than 1 percentage point (annual rate; compounded semiannually). The authority to make such increases was intended to enable the Secretary to increase the rate of interest to keep it competitive with comparable alternative yields.

Series EE savings bonds were yielding 9 percent (annual rate; compounded semiannually) on bonds held to maturity, which was an 8-year period. The yield on Series HH bonds was 8½ percent on bonds that matured in 10 years, with the interest paid semiannualy by check. The Secretary last used his discretionary authority to put these rates into effect on May 1, 1981. Series EE and HH bonds are not marketable securities.

No person could purchase more than $15,000 in Series EE bonds, at issue price, in any one year. The limit on purchases of Series HH bonds was $20,000 per year.

The income tax payment on the interest accruals on a still outstanding Series E or Series EE savings bond may be taxed as current income, or tax and income may be deferred at the taxpayer's option until the bond is redeemed.

Reasons for Change

The general increase in the structure of interest rates since the start of 1978 resulted in a net $30 billion excess of redemptions over sales of U.S. savings bonds by the time this legislation was enacted.

The Secretary's discretionary authority to raise the interest rate on savings bonds was used last on May 1, 1981, to raise the rates on Series EE bonds to 9 percent and to 8½ percent on Series HH bonds. The Secretary did not use the authority to increase the rate on Series EE bonds to 10 percent on November 1, 1981, and announced then his intention to seek legislation to permit interest rates on savings bonds to be varied with current market rates. The Secretary stated that increasing the savings bond rate might reduce the net redemptions, but it could be expensive in the long run (because increases in savings bond interest rates have been applied to all outstanding savings bonds), if market interest rates decline.

---

*For legislative background of the provision, see H.R. 4961, as reported by the Senate Finance Committee, sec. 289, S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 402-406; and H. Rept. No. 97-760 (August 17, 1982), p. 670 (Joint Explanatory Statement of the Committee of Conference).

Prior statutory rules prescribed the frequency with which the interest rate on savings bonds could be increased. Experience with making periodic statutory adjustments in interest rates to keep savings bond yields reasonably competitive with the yields on comparable private alternatives had been unsatisfactory. Congress, therefore, concurred in the Administration request for authority to be able to maintain a closer relationship between savings bond yields and current market interest rates on comparable maturities.

Explanation of Provision

The Act provides that the Secretary of the Treasury, with the approval of the President, may fix the investment yield on any United States saving bond. The Secretary also is authorized to provide for increases and decreases in the yield on any outstanding United States savings bond. With this authority, the Secretary, however, may not decrease the yield on any bond for the period it is held below the minimum yield that was guaranteed for such period at the time of its issuance or at the time the bond entered an extended maturity period; i.e., the bond was held past its maturity date.

Under the authority provided in this Act, the Treasury Department began issuing a new market-based variable rate Series EE savings bond on November 1, 1982. The interest rate on these bonds will be 85 percent of the average yield on outstanding 5-year Treasury marketable securities for the entire period the bond is held, if the bond is held at least 5 years. The minimum guaranteed rate for all Series EE savings bonds purchased in the next 6 months and held at least 5 years will be 7.5 percent.

The new Series EE bonds will mature in 10 years, and the minimum maturity value (which also will be the face value) will be double the purchase price—the result of compounding the purchase price semiannually at the guaranteed minimum 7.5 percent annual rate of interest. If a Series EE bond is held for less than 5 years, it will accrue interest at predetermined interest rates that increase gradually throughout the 5-year period to the guaranteed minimum rate. At the start of the new program, the interest rate was set at 5.5 percent for savings bonds redeemed after one year.

Series EE bonds issued before November 1, 1982, will be treated as new issues as of November 1, 1982, at their accrued value at that time. If the bond is held for at least an additional 5 years, the bond will receive the market-based variable investment yield, just as though it had been issued initially on November 1, 1982. If the bond is held for less than an additional 5 years, the investment yield will follow the predetermined schedule applicable to the bond when it was issued initially.

Interest rates on Series EE bonds will continue to be compounded semiannually, and the accrued interest earned will be included in the redemption value of the bonds when they are redeemed. This accrued interest will remain exempt from State and local government income taxes, and Federal income tax may be deferred until the bonds are cashed or reach final maturity. Bonds that are lost, stolen or destroyed will be replaced by the Treasury Department, as was true in the past.

Series HH bonds no longer will be issued for cash. They will continue to be issued in exchange for Series E and Series EE bonds and Savings Notes with a total redemption value of at least $500. New issues of Series HH bonds will pay interest semiannually at a flat rate of 7.5 percent. Persons who receive Series HH bonds by exchange may continue to defer reporting the interest income from the exchanged securities, for Federal tax purposes, until the HH bonds are redeemed or reach final maturity. Older Series H and Series HH bonds will continue to receive their guaranteed interest rates to the end of their original or current extended maturity period.

To dispel confusion that may arise because of several different designations of outstanding savings bonds, Congress has indicated its intent that all references in the Second Liberty Bond Act to series E and H savings bonds should be considered as generic references to all United States savings bond series.

Effective Date

This provision became effective on the date of enactment.

Budget Effect

This provision will have no direct effect on the level of budget receipts. It is expected to reduce budget outlays by $329 million in fiscal year 1983, $691 million in fiscal year 1984 and $858 million in fiscal year 1985.

b. 4¼ percent limit on interest rate on bonds

Prior Law

Obligations of the United States are defined as bonds if they have a maturity when issued that is longer than 10 years. The rate of interest that may be paid on a bond may not exceed 4¼ percent, except that up to $70 billion in outstanding bonds with rates of interest above 4¼ percent could be issued to be held by the public. The exception for a specified amount of bonds—initially $10 billion—was enacted in 1971, and it applied to all bonds with rates above the ceiling. An amendment in 1973 applied the limitation only to bonds held by the public, i.e., holdings of Federal agencies and the Federal Reserve Banks were not included.

Reasons for Change

The Treasury Department exhausted its $70 billion authority to issue long-term bonds in February 1982 and was forced to cancel its regular quarterly issues of 20-year bonds in April and July, and 30-year bonds in May and August.

Congress and the Treasury Department believed it was desirable to continue to issue bonds to maintain a presence in all maturity sectors of the bond market and to resist shortening the maturity of the public debt. Close to half of the privately held marketable debt matures in one year and more than three-fifths within 2 years. The average maturity of all issues was 4 years at the end of July 1982.

The inability of the Treasury Department to continue the quarterly bond cycle might have disrupted the bond market. Disruption would occur because of market uncertainty about Treasury plans and how investable funds should be allocated among private and public issues and among different maturities. In addition, the Treasury Department believed that maintaining a stable bond market reduces borrowing costs in the long run, even though the interest rate when any one bond is issued may be high in terms of historical patterns.

Explanation of Provision

The Act increases the exception from the interest rate ceiling by $40 billion, thus raising the exception to $110 billion. The Treasury Department will be able to continue to operate in the long-term bond market for about two years with this authority, if it continues its long-term bond debt management practices of the past few years.

In addition, all bonds issued under the additional exception must be issued in registered form.

Effective Date

This provision became effective on the date of enactment.

Budget Effect

The effects of this provision on budget receipts and budget outlays are expected to offset each other.

5. Disclosure of Tax Returns*

a. Disclosure of tax return information for nontax criminal investigation purposes (sec. 356 of the Act and sec. 6103(i) of the Code)

Prior Law

Overview

Tax returns and taxpayer return information (i.e., return information submitted to the Internal Revenue Service (IRS) by the taxpayer or his representative) could be disclosed for Federal nontax criminal investigation purposes only on the grant of an ex parte order by a Federal district court judge. Return information that is submitted to the IRS by someone other than the taxpayer or his representative could be secured on written request by certain officers and employees of the Federal government. The IRS, in certain circumstances, could disclose return information on its own initiative.

Disclosure pursuant to court order

Returns and taxpayer return information could be disclosed by the IRS to personnel of other Federal agencies for nontax criminal investigation purposes only on the grant of an ex parte order by a Federal district court judge.

Personnel to whom tax information could be disclosed

Tax information could be disclosed only to officers and employees of a Federal agency who are personally and directly engaged in the preparation for any administrative or judicial proceeding (or any investigation that may result in such a proceeding) pertaining to the enforcement of a Federal nontax criminal statute.

Individuals who may authorize an application for court-ordered disclosure

The following individuals could authorize the application for a court order: the head of a Federal agency, the Attorney General, the Deputy Attorney General, or an Assistant Attorney General.

Court order standards

A Federal district court judge could grant an order for disclosure if the judge determined that:

---

*For legislative background of the provision, see: Senate floor amendments, 128 Cong, Rec. S. 9002-9008 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 671-678 (Joint Explanatory Statement of the Committee of Conference).

(1) There is reasonable cause to believe, based upon information believed to be reliable, that a specific criminal act has been committed;

(2) There is reason to believe that the return or return information is probative evidence of a matter in issue related to the commission of such criminal act; and

(3) The information sought to be disclosed cannot reasonably be obtained from any other source, unless it is determined that, notwithstanding the reasonable availability of the information from another source, the return or return information sought constitutes the most probative evidence of a matter in issue relating to the commission of such criminal act.

Application for disclosure of return information other than taxpayer return information

The head of any Federal agency, the Attorney General, the Deputy Attorney General, or an Assistant Attorney General could obtain return information (other than taxpayer return information) by written request to the IRS. (This category of information is tax information that the IRS has received from someone other than the taxpayer under investigation or his representative.)

Contents of application

A request for return information (other than taxpayer return information) had to set forth, among other information, the specific reason or reasons why the disclosure is or may be material to the proceeding or investigation.

Taxpayer identifying information

The name and address of a taxpayer could be disclosed, pursuant to written request, for use in a nontax criminal investigation.

Disclosure of return information (other than taxpayer return information) to apprise appropriate officials of possible criminal activities

Return information (other than taxpayer return information) that may constitute evidence of a violation of Federal criminal laws could be disclosed by the IRS to the extent necessary to apprise the head of the appropriate Federal agency charged with the responsibility of enforcement of such laws.

Under this provision, the taxpayer's identity could be disclosed if there was return information (other than taxpayer return information) that might constitute evidence of a violation of Federal criminal laws.

Use of tax information in administrative or judicial proceedings

In general, returns or return information disclosed by the IRS to a Federal agency could be entered into evidence in any administrative or judicial proceeding pertaining to enforcement of a nontax Federal criminal statute. A return or return information that was disclosed pursuant to a court order could be entered into evidence only if the court found that it was probative of a matter in issue relevant in establishing the commission of a crime or the guilt of a party.

Reasons for Change

The prior law rules governing the disclosure of tax returns and return information for nontax criminal investigation purposes were enacted by the Tax Reform Act of 1976. A major reason for enacting those provisions was the concern of Congress with the fact that the Justice Department and other Federal agencies were able to obtain tax returns and return information almost at their sole discretion. It was the intent of Congress, in enacting the disclosure provisions contained in the Tax Reform Act of 1976, that the private papers which an American citizen is compelled by the tax laws to disclose to the Internal Revenue Service be entitled to essentially the same degree of privacy as those private papers maintained solely in his home. Thus, Congress decided that the Justice Department and any other Federal agency responsible for the enforcement of a nontax criminal law should be required to obtain court approval for the inspection of a taxpayer's return or return information submitted by, or on behalf of, a taxpayer.

Congress continued to hold the concerns that led to the enactment of the disclosure reforms in the Tax Reform Act of 1976. However, since the enactment of those provisions, Congress made a thorough examination to determine whether those provisions could be modified in a manner to facilitate legitimate law enforcement needs while, at the same time, preserving the basic principle that a taxpayer's return generally should be confidential and should be disclosed, in narrow circumstances, only where those law enforcement needs outweigh the need to preserve taxpayer confidentiality. Moreover, the conferees on the Economic Recovery Tax Act of 1981 made a commitment to take appropriate legislative action in this area. The Act fulfills that commitment.

Congress had two primary concerns with the prior law disclosure provisions. These related to the stringency of the standards that had to be met in order to obtain an ex parte order for the disclosure of returns and taxpayer return information for nontax criminal investigation purposes and the narrow category of individuals who could authorize applications for ex parte disclosure orders. Thus, Congress decided to relax somewhat the court order standards and to provide less centralized authorization procedures. It was the understanding of Congress that the probative evidence standard of prior law was perceived by law enforcement officials to be, on its face, an extremely difficult standard. Thus, among other, more minor, modifications to the court order standards, the Act substitutes the more reasonable standard of relevancy for the probative evidence standard. (Congress understands that this is the standard that previously has been followed by most courts.) The decision to decentralize the authority within the Justice Department to authorize applications for ex parte disclosure orders was responsive to the concern that the centralization of this authority in the national office often could jeopardize criminal cases because of the time involved in securing the necessary authorizations. These changes, which Congress believed maintain the present law balance between fundamental privacy rights of taxpayers and legitimate Federal law enforcement needs, were intended to ease administratively the flow of tax information within the restrictive parameters of the law.

In addition to making needed modifications of prior law, Congress decided that the disclosure provisions should be expanded for two new purposes. First, the Act permits the Internal Revenue Service to disclose return information (including taxpayer return information) in certain emergency circumstances. Second, the Act permits law enforcement personnel to receive, pursuant to court order, tax information for the purpose of locating Federal fugitives from justice. In these two areas, Congress determined that the taxpayer's need for confidentiality is outweighed by legitimate law enforcement needs.

Explanation of Provisions

Overview

The primary changes made by the Act include: (1) the modification of the standards for the granting of an ex parte order for the disclosure of tax returns and return information and allowing Federal district court magistrates to issue those orders; (2) an expansion in the number of personnel who will be permitted to request disclosure; (3) new authority allowing court-ordered disclosure of return information for purposes of locating Federal fugitives from justice; and (4) new authority for the IRS to disclose return information, on its own initiative, in emergency circumstances.

Disclosure pursuant to court order

The Act allows a Federal district court magistrate, as well as a Federal district court judge, to grant an ex parte order for the disclosure of returns or return information.

Personnel to whom tax information may be disclosed

The Act expands the category of personnel to whom disclosure can be made to include officers and employees of a Federal agency who are personally and directly engaged in any Federal grand jury proceeding pertaining to enforcement of a Federal nontax criminal statute.

Individuals who may authorize an application for court-ordered disclosure

The Act eliminates the authority of Federal agency heads (other than the Attorney General) to authorize applications for court-ordered disclosure. However, the number of individuals within the Department of Justice who can authorize applications is expanded to include: the Associate Attorney General, any United States Attorney, any special prosecutor, and any attorney in charge of a criminal division organized crime strike force.

Court order standards

Under the Act, a Federal district court judge or magistrate may grant an order for disclosure of tax returns or return information if the judge or magistrate determines that:

(1) There is reasonable cause to believe, based upon information believed to be reliable, that a specific criminal act has been committed;

(2) There is reasonable cause to believe that the return or return information is or may be relevant to a matter relating to the commission of such act; and

(3) The return information is sought exclusively for use in a Federal criminal investigation or proceeding concerning such act, and the information sought to be disclosed cannot reasonably be obtained, under the circumstances, from another source.

With respect to the third standard, it would not be reasonable to obtain tax information from another source if, for example, the information cannot be obtained in an expeditious manner in a case where time is an essential factor, or if an attempt to obtain the information elsewhere would seriously impair a criminal investigation or proceeding.

Disclosure to locate Federal fugitives from justice

Persons who may authorize an application for court-ordered disclosure will be permitted also to authorize an application for the disclosure of returns and return information solely for the purpose of locating Federal fugitives.

A Federal district court judge or magistrate may authorize a disclosure order if the judge or magistrate determines that:

(1) A Federal arrest warrant relating to the commission of a Federal felony offense has been issued for an individual who is a fugitive from justice;

(2) The return of such individual or return information with respect to such individual is sought exclusively for use in locating such individual; and

(3) There is a reasonable cause to believe that such return or return information may be relevant in determining the location of such individual.

It was intended that this provision will be used to locate fugitives who are considered to be violent or dangerous or who pose a substantial threat to society.

Application for disclosure of return information other than taxpayer return information

The Act expands the number of individuals who can authorize a written request for disclosure from the IRS, for return information other than taxpayer return information, to include the Inspector General of any Federal agency, the Associate Attorney General, the Director of the Federal Bureau of Investigation, the Administrator of the Drug Enforcement Administration, any United States Attorney, any special prosecutor, and any attorney in charge of a criminal division organized crime strike force.

Contents of application

A request for return information (other than taxpayer return information) must set forth, among other information, a showing of the specific reason or reasons why the disclosure is or may be relevant to (rather than material to) the proceeding or investigation.

Taxpayer identifying information

A taxpayer's social security number, as well as the taxpayer's name and address, may be disclosed, pursuant to written request, for use in a nontax criminal investigation.

It was intended that taxpayer identity information be treated as taxpayer return information unless return information (other than taxpayer identity information) is requested and disclosed pursuant to such written request.

Disclosure of return information to apprise appropriate officials of criminal activities or emergency circumstances

The IRS is provided with additional authority to disclose return information (including taxpayer return information) in certain emergency circumstances.

Specifically, under circumstances involving an imminent danger of death or physical injury to any individual, the IRS is permitted to disclose return information to the extent necessary to apprise appropriate officers or employees of any Federal or State law enforcement agency of such circumstances. Furthermore, under circumstances involving the imminent flight of any individual from Federal prosecution, the IRS may disclose return information to the extent necessary to apprise appropriate officers or employees of any Federal law enforcement agency of such circumstances

Such disclosures will be subject to the safeguard and annual reporting requirements of section 6103(p). Moreover, it was intended that the IRS utilize its disclosure authority in an efficient and effective manner. The provision relating to imminent flight from Federal prosecution is intended to cover individuals who could be prosecuted for flight from prosecution, as a separate Federal offense, and circumstances where an individual has attempted to change identity or intends to flee from the country.

Use of tax information in judicial or administrative proceedings

The use of returns and return information in judicial or administrative proceedings not involving tax administration is expanded.

Specifically, this information also may be disclosed in any judicial or administrative proceeding pertaining to the enforcement of a civil forfeiture that is related to a nontax Federal criminal statute or to the extent required by court order pursuant to 18 U.S.C. sec. 3500 or rule 16 of the Federal Rules of Criminal Procedure.

Effective Date

The provision was effective with respect to disclosures made after the date of enactment.

b. Civil damages for unauthorized disclosure of returns and return information (sec. 357 of the Act and new sec. 7431 of the Code)

Prior Law

A person who knowingly or negligently disclosed a return or return information with respect to a taxpayer, in violation of the disclosure restrictions, could be sued in a civil action for damages in a district court of the United States.

Reasons for Change

While Congress believed that the threat of a civil suit is an appropriate method to deter unauthorized disclosure of tax information, it was not felt to be appropriate in the case of disclosures by U.S. officers or employees. Instead, Congress believed that it would be more appropriate for the United States, which normally could be expected to exercise control over its employees, to be the party that is subject to a civil action for damages when one of its officers or employees makes a wrongful disclosure.

Explanation of Provision

Under the Act, if a U.S. officer or employee knowingly or negligently discloses return information in violation of the disclosure restrictions, the wronged party will be permitted to bring a civil action for damages against the U.S. (rather than against the officer or employee). Of course, an officer or employee who makes a wrongful disclosure still will be subject to all administrative disciplinary actions, as well as potential criminal sanctions.

Effective Date

The provision applies to disclosures made after the date of enactment.

c. Disclosure of returns and return information for use in certain audits by the General Accounting Office (sec. 358 of the Act and sec. 6103(i)(7) of the Code)

Prior Law

The General Accounting Office has access to tax returns and return information for the purpose of conducting an audit of the Internal Revenue Service or the Bureau of Alcohol, Tobacco, and Firearms, and for the purpose of auditing the safeguards used by other agencies to safeguard returns and return information. However, before the GAO receives tax returns or return information in connection with an audit, it must notify the Joint Committee on Taxation of the audit. The Joint Committee may disapprove an audit by a vote of at least two-thirds of its members within 30 days of receipt of notice of the proposed audit.

In addition, the GAO is permitted access to returns and return information when it is acting as an agent for the Committee on Ways and Means, Committee on Finance, or Joint Committee on Taxation.

Reasons for Change

Under prior law, the GAO did not have independent authority to review tax information held by other Federal agencies, except in the case where such information was held by the IRS or the Bureau of Alcohol, Tobacco, and Firearms or where the GAO was auditing the safeguards used by other agencies to protect return information. Congress believed that expanding the access of GAO to tax information, in certain limited circumstances, would permit the GAO to operate more efficiently as an arm of Congress. Thus, the Act allows the GAO to have access to tax information in the possession of any Federal agency when the GAO is auditing a program or activity of the agency which involves the use of tax information. Furthermore, under certain circumstances, the GAO is permitted access to tax information that a Federal agency could have requested for nontax administration purposes.

Explanation of Provision

Under the Act, GAO access to tax returns and return information is expanded to include any returns or return information obtained by a Federal agency for use in any agency program or activity. This information will be open (upon written request) to officers and employees of the GAO only to the extent necessary in auditing such program or activity. Furthermore, the GAO is permitted access to returns and return information that have not been obtained by a Federal agency in certain circumstances, provided that the agency is authorized to obtain the information for use in the program or activity that is the subject of the GAO audit. This "second-tier" access is limited to return information of the type that may be disclosed under Code secs. 6103(l) or (m).[1] Congress intended that before the GAO requests any second-tier access, it will take into account the burdens that such access might impose upon the Internal Revenue Service.

The Internal Revenue Service may refuse to disclose tax information to the GAO if such disclosure would identify a confidential informant or seriously impair a civil or criminal tax investigation.

The pre-audit notification procedures and Joint Committee veto authority of present law are retained. This notification should include (1) a description of the audit to be undertaken, including its scope and purpose; (2) an explanation of the use that will be made of tax information; and (3) assurance that in using tax information, and in formulating its recommendations which will result from the audit of programs that involve the use of tax information, the GAO will consider any potential impact on tax administration and taxpayer confidentiality.

In addition, within 90 days after the completion of any audit with respect to which the GAO had access to tax returns or return information, the GAO is required to notify the Joint Committee on Taxation of the completion. Such written notification will include (1) a description of the use of the returns and return information by the Federal agency involved; (2) such recommendations with respect to the use of returns and return information by the Federal agency as the Comptroller General deems appropriate; and (3) a statement of the impact of any such recommendations on the confidentiality of returns and return information and on tax administration. The GAO also is expected to notify the Joint Committee of any recommendations that will affect tax administration, directly or indirectly.

---

[1] In general, this includes tax information that may be disclosed to the Social Security Administration and Railroad Retirement Board, the Department of Labor and Pension Benefit Guaranty Corporation, the Department of Health and Human Services, Federal, State, and local child support enforcement authorities, and the Department of Agriculture and State food stamp agencies. It also includes taxpayer identity information that may be disclosed to the National Institute for Occupational Safety and Health, and to other Federal Agencies for certain debt collection purposes.

The present law authority for the GAO to gain access to tax information when it is acting as an agent for the Committee on Ways and Means, the Committee on Finance, or the Joint Committee on Taxation is retained. Moreover, the GAO may continue audit activity, which involves access to tax information, pursuant to any current agency designation, which is in process as of the date of enactement.

Effective Date

The provision became effective on the day after the date of enactment.

6. Exemption of veterans organizations (sec. 354 of the Act and secs. 501(c)(19) and 501(c)(23) of the Code)*

Prior Law

Under prior law, a domestic post or organization of war veterans (or an auxiliary unit or society of, or a trust or foundation for such post or organization) was tax exempt if at least 75 percent of its members are "war veterans" and substantially all the other members are veterans or cadets, or are spouses, widows, or widowers of such individuals, and if no part of its net earnings inures to the benefit of any private individual.

Reasons for Change

With a prolonged period of peace at hand, there are few "war veterans", whether or not they are presently serving in the military. This situation, along with the natural attrition rate among surviving war veterans, has made it increasingly difficult for veterans organizations to meet the membership requirements for tax-exemption under the Code. Congress believed that a relaxation of the membership requirement would preserve the essential character of these organizations as being veteran oriented.

Explanation of Provisions

The Act modifies the membership requirement of prior law to allow tax exemption for a veterans organization (which satisfies the other requirements of law), if 75 percent of its members are past or present members of the U.S. Armed Forces (whether or not war veterans) and its remaining membership consists substantially of cadets or spouses, widows, or widowers of past or present members of the U.S. Armed Forces or of cadets. In addition, the Act allows exemption for any veterans association founded before 1880, 75 percent of the members of which are past or present members of the U.S. Armed Forces, and the primary purpose of which is to provide insurance and other benefits to veterans and their dependents.

Effective Date

The provision applies to taxable years beginning after date of enactment.

Revenue Effect

This provision is expected to reduce revenues by less than $5 million per year.

---

*For legislative background of the provision, see: Senate floor amendments, 128 Cong. Rec. S8884 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), p. 679 (Joint Explanatory Statement of the Committee of Conference).

7. Exemption of amateur athletic organizations (sec. 286 of the Act and secs. 170 and 501 of the Code)*

Prior law

Athletic organizations that teach youth or are affiliated with charitable organizations may qualify for tax exemption and are eligibile to receive tax-deductible contributions if they meet the general requirements for charitable or educational organizations. Also, prior law expressly provided that certain other athletic organizations may qualify for tax exemption and tax-deductible contributions if organized and operated exclusively to foster national or international amateur sports competition, but only if no part of the organization's activities involve the provision of athletic facilities or equipment and if it meets the other general requirements for charitable organizations (sec. 501(c)(3).

Reasons for Change

Although concerned with the potential abuse of tax-exemption, Congress believed that there are a number of amateur sports organizations that provide facilities to their members without being abusive. Congress felt that such organizations should be encouraged, through favorable tax treatment, to continue the sponsorship of, and training for, national and international sports competition.

Explanation of Provisions

The Act allows tax-exempt status to amateur athletic organizations that foster national and international amateur sports, if they are also organized primarily to conduct national or international competition in sports, or to support and develop amateur athletes for such competition. Such organizations qualify for tax-exempt status whether or not the organization provides facilities or equipment to its members, and whether or not its membership is local or regional in nature.

However, Congress also was concerned that some taxpayers may claim deductions for transfers to or for the use of amateur athletic organizations in cases where there is a direct benefit from the transfer to the taxpayer or other persons. Congress intended that this provision not modify the rules of existing tax law that a deduction is not allowed when there is a substantial, direct, personal benefit to the taxpayer or to any other person other than the amateur athletic organization.

---

*For legislative background of the provision, see Senate floor amendments, 128 Cong. Rec. S8919 (July 22, 1982); and H. Rep. No. 97-760 (August 17, 1982), pp. 679-680 (Joint Explanatory Statement of the Committee of Conference).

Effectice Date

The provision is effective as of October 5, 1976.

Revenue Effect

This provision is expected to reduce revenues by less than $5 million per year.

8. New Jersey revenue sharing allocation (sec. 287 of the Act)

Prior Law

The general revenue sharing program was established under the authority of the State and Local Fiscal Assistance Act of 1972 (Public Law 92–512) and was extended with modifications by the State and Local Fiscal Assistance Amendments of 1976 (Public Law 94–488). The program was further extended, with modifications in the ability of State governments to qualify for funds, by the State and Local Fiscal Assistance Amendments of 1980 (Public Law 96–604). The 1980 Amendments provided for payments to units of local government in the amount of $4,566,700,000 for each of the fiscal years 1981, 1982, and 1983.

Under prior law, revenue sharing funds were distributed to units of local government based on a formula that allocated funds to geographic areas within a State and provides for the division of those funds among the units of local government within that area. One of the factors taken into account in allocating general revenue sharing funds is the tax effort of the units of government that are eligible for funds.

Reasons for Change

In general, a tax must be assessed and collected by a qualifying unit of government in order for that tax to be counted toward the jurisdiction's tax effort. The New Jersey Franchise and Gross Receipts Tax, prior to 1980, was assessed by the State but collected and retained by units of local government. As the Census Bureau determines taxes for general statistical purposes, State-imposed but locally collected and retained taxes are treated as local taxes. It came to the attention of Congress that in 1980 the New Jersey legislature amended the Franchise and Gross Receipts Tax to provide for its assessment and collection by the State, with the proceeds of the tax made available for use by units of local government. Under the State and Local Fiscal Assistance Amendments of 1980, this change by the New Jersey legislature would preclude consideration of the Franchise and Gross Receipts Tax as an adjusted tax of units of local government for purposes of allocating revenue sharing funds within the State of New Jersey. Congress concluded that this change could have a disruptive effect on the pattern of revenue sharing payments to units of local government in New Jersey. Accordingly, Congress agreed to a provision that will preserve the present formula for distributing those funds with respect to the classification of the Franchise and Gross Receipts Tax for a brief period of time, in order to allow the State of New Jersey to decide whether to convert the Franchise and Gross Receipts Tax back to an adjusted tax of units of local government. Congress did not intend by its action to express a judgment as to the appropriate classification for the Franchise and Gross Receipts Tax, but simply intended to allow the State of New Jersey a brief period of time in which to take the initiative to correct this problem if it deems such action appropriate.

Explanation of Provision

The Act provides that the New Jersey Franchise and Gross Receipts Tax shall be deemed an adjusted tax of units of local government for purposes of allocating revenue sharing funds to units of local government in New Jersey for the quarterly payment made with respect to the quarter beginning on October 1, 1982. However, the Franchise and Gross Receipts Tax shall be deemed an adjusted tax of units of local government in New Jersey for purposes of future quarterly revenue sharing payments only if, prior to January 1, 1983, the Governor of the State of New Jersey notifies the Secretary of the Treasury that, prior to January 1, 1983, the State amended the New Jersey Franchise and Gross Receipts Tax statutes to provide for collection and retention of such taxes by units of local government for years beginning as of January 1, 1983. Without such action by the Governor of the State of New Jersey, the Franchise and Gross Receipts Taxes would cease to be deemed an adjusted tax of units of local government quarterly payment periods beginning after December 31, 1982.

Effective Date

The amendment made by the provision is effective after September 30, 1982.

Revenue Effect

This provision has no effect on budget receipts.

9. Relief for the Jefferson County Mental Health Center, Lakewood, Colorado (sec. 290 of the Act)*

Prior Law

Under prior law and present law, employees of a nonprofit organization are excluded from social security coverage unless the organization files with the Internal Revenue Service a certificate waiving its exemption from taxation. Employees of the organization at the time the waiver certificate is filed are given the option to participate in the program and, if they decide to do so, must sign a form accompanying the certificate waiving their right of exemptions. All employees subsequently hired by the organization are automatically covered under the program.

Reasons for Change

Congress understood that the Jefferson County Mental Health Center, Inc. (the "Center"), an exempt organization described in section 501(c)(3), filed a waiver certificate in 1963 pursuant to section 3121(k)(1)(A), by which the Center waived the exemption for payment of social security (FICA) taxes. In accordance with that filing, the Center began deducting the employee portion of FICA and paid that portion, along with its portion, to the Internal Revenue Service.

As a result of a mistaken response by the Center to a questionnaire circulated by the Internal Revenue Service, the Western Region Service Center of the Service at Ogden, Utah, mistakenly notified the Center by letter dated February 28, 1975, that the Center was not liable for the FICA taxes. As a result of that letter, and follow-up instructions received by telephone from the Service, the Center contacted those persons whom they were able to locate who had been employed by the Center (133 in number), during the calendar years 1972 through 1974, and each of those individuals was offered an election as to whether or not he or she wished to be covered over the prior 3 years (1972 through 1974) and in the future under FICA.

Of those contacted, 103 elected not to be covered by FICA, and to those 103 employees and former employees, the Center paid out $74,128 from its own funds as refunds covering contributions by and for them to FICA over the 3 years (1972, 1973, and 1974). Those employees unable to be contacted were treated as though they had elected to be covered. No refunds were made to those employees nor to those who elected to remain covered (a total of 30 in both categories). This action was taken due to assurances by the Internal Revenue Service that a prompt refund would be made to the Center of the employees' tax and the tax the Center had paid, once refunds had been advanced by the Center out of its own funds to those employees.

---

*For legislative background of the provision, see: H.R. 1635 as reported by the House Committee on Judiciary (Sept. 22, 1981) and passed by the House (Oct. 6, 1981); H.R. 4961, as reported by the Senate Finance Committee, sec. 298; S. Rep. No. 97-494, Vol. 1 (July 12, 1982), pp. 412-413; and H. Rep. No. 97-760 (August 17, 1982), pp. 685 (Joint Explanatory Statement of the Committee of Conference.

After the Center had paid the employees $74,128, the Western Region Service Center, on May 14, 1975, notified the Center that the Service had found a valid waiver certificate on file, and that neither the refunds nor the employees' elections should have been made.

Those employees who elected not to be covered by FICA and who remained employees of the Center after January 1, 1975, have been treated by the Center as continuing not to be covered by FICA in accordance with their election made pursuant to the Service's instruction arising out of the February 28, 1975, letter.

The Service has advised the Center that there is no provision in law which would authorize administrative relief for the action which the Center has taken in reliance on the letter from the Service of February 28, 1975.

As an equitable matter for the relief of the Center, Congress agreed to a provision to compensate the Center in full settlement of all claims arising out of the erroneous advice of the Internal Revenue Service to the Center that the contributions had been incorrectly withheld.

Explanation of Provision

The provision authorizes the payment of $50,000 to the Jefferson County Mental Health Center in full settlement of its claims against the United States for repayment of the $74,128 the Center refunded to its employees for individual social security contributions after the Internal Revenue Service erroneously advised the Center that the contributions had been incorrectly withheld. The Act also provides that no part of this $50,000 in excess of 10 percent shall be paid out for services rendered in connection with this claim.

Effective Date

The provision was effective on enactment.

Revenue Effect

The provision authorizes a single payment of $50,000. There is no direct effect on budget receipts.

10. Award of reasonable litigation costs where taxpayer prevails and government position was unreasonable (secs. 292 (a) and (b) of the Act, new sec. 7430 and sec. 6673 of the Code)*

Prior Law

The Civil Rights Attorney's Fees Awards Act of 1976

The Civil Rights Attorney's Fees Awards Act of 1976 (42 U.S.C. sec. 1988) provided, in part, that in any civil action or proceeding brought by or on behalf of the United States to enforce, or charging a violation of, a provision of the Internal Revenue Code, the court in its discretion could allow the prevailing party, other than the United States, reasonable attorney's fees as a part of the costs. This provision had limited applicability to tax litigation and resulted in very few fee awards, because the provision was limited to actions brought by or on behalf of the Federal Government (that is, to cases in which the taxpayer was the defendant). Most civil tax litigation is initiated by the taxpayer who brings suit against the Government. In the United States Tax Court, the taxpayer is the petitioner in a deficiency proceeding. In the Federal district courts and the U.S. Court of Claims, the taxpayer is the plaintiff suing the Government for a refund.

The Equal Access to Justice Act

In 1980, as part of Public Law 96-481, Congress enacted the Equal Access to Justice Act (28 U.S.C. sec. 2412) which, in part, authorizes awards to a prevailing party, other than the United States, of fees and other expenses incurred by that party in any civil action (other than tort cases) brought by or against the United States in any court having jurisdiction of that action, unless the court finds that the position of the United States was substantially justified or that special circumstances make an award unjust. This provision applied, specifically, to cases in Federal district courts and the United States Court of Claims. However, the provision was not applicable to cases in the United States Tax Court.[1]

Because this provision applied to cases in which taxpayers are plaintiffs, and not merely to cases brought by the Government, it created a greater potential for fee awards in tax cases than did the Civil Rights Attorney's Fees Awards Act of 1976. The provision became effective on October 1, 1981, and was to continue to apply through final disposition of any action commenced before October

---

*For legislative background of the provision, see: H.R. 4961, as reported by the House Ways and Means Committee, sec. 103; H. Rep. No. 97-404, (December 4, 1981), pp. 10-16; and H. Rep. No. 97-760 (August 17, 1982), pp. 686-689 (Joint Explanatory Statement of the Committee of Conference).

[1] This is because the Equal Access to Justice Act is contained in Title 28 of the United States Code, which deals with courts created under Article III of the United States Constitution. The United States Tax Court was established under Article I of the United States Constitution.

1, 1984. The provision repealed the applicability of the Civil Rights Attorney's Fees Awards Act of 1976 to tax litigation.

Under the Equal Access to Justice Act, fees and other expenses that may be awarded to a prevailing party include the reasonable expenses of expert witnesses, the reasonable cost of any study, analysis, engineering report, test, or project which is found by the court to be necessary for the preparation of the party's case, and reasonable attorney's fees. In general, no expert witness may be compensated at a rate that exceeds the highest rate of compensation for expert witnesses paid by the United States. Attorneys' fees in excess of $75 per hour may not be awarded unless the court determines that a higher fee is justified.

In general, fees and expenses may be awarded under the Act only to individuals, corporations, and sole owners of businesses satisfying limitations on their net worth and their number of employees.

Damages assessable for instituting proceedings before the Tax Court merely for delay

Under prior law, if it appeared to the Tax Court that proceedings before it had been instituted by a taxpayer merely for delay, then the court could award damages to the United States. Such damages could not exceed $500.

Reasons for Change

Congress believed that taxpayers who prevail in civil tax actions should be entitled to awards for litigation costs and attorneys' fees up to $25,000 when the United States has acted unreasonably in pursuing the case. Fee awards in such tax cases will deter abusive actions or overreaching by the Internal Revenue Service and will enable individual taxpayers to vindicate their rights regardless of their economic circumstances.

Moreover, Congress was concerned because the Equal Access to Justice Act, which provides for litigation costs awards in tax cases brought in the Federal district courts and the U.S. Claims Court does not apply to proceedings in the U.S. Tax Court. Since most tax litigation occurs in the U.S. Tax Court, few taxpayers will be able to obtain awards. In addition, the availability of awards in only these courts encourages a taxpayer to choose the forum in which to pursue litigation based on whether awards of litigation costs are available. Furthermore, Congress believed that one set of rules should apply to awards of litigation costs in tax cases, whether the action is brought in a U.S. district court, the U.S. Claims Court or the U.S. Tax Court.

Finally, Congress was concerned with the ever-increasing caseload of the Tax Court and the impact that this legislation may have on that caseload. Thus, Congress decided to limit the awarding of litigation costs to only those cases in which the Government has acted unreasonably. This will reduce any incentive to avoid settlement and pursue litigation in the hope of winning an award of litigation costs. In addition, Congress decided to increase the damages, i.e., penalty, that may be assessed against a taxpayer when proceedings are instituted for delay, and to expand the circumstances under which the Tax Court may assess those damages. Because of Congress' concern for efficient tax administration and the backlog of cases pending before the U.S. Tax Court, the Act provides for a termination of the litigation costs provisions for proceedings commenced after December 31, 1985, so that Congress can review the operation and effect of the provision.

Explanation of Provisions

Overview

The Act generally provides that taxpayers who prevail in civil tax actions in which the position of the United States was unreasonable may be awarded reasonable litigation costs (including attorney's fees) up to a cap of $25,000. An award of reasonable litigation costs to the prevailing party in a civil tax action is discretionary with the court hearing the case.

Litigation costs may be awarded in civil actions or proceedings brought by or against the United States (or any agency, officer, or employee of the United States acting in his or her official capacity) in any United States court,[2] including the Tax Court, in connection with the determination, collection, or refund of any tax, interest, or penalty. Civil actions and proceedings include proceedings to enforce a summons, jeopardy assessments, wrongful levies, and interpleaders (*i.e.*, generally, a proceeding to enable a person to compel parties making the same claim against him to litigate the matter between themselves). Thus, parties who are plaintiffs or defendants in suits in connection with the determination, collection, or refund of any tax, interest, or penalty imposed by the Internal Revenue Code may be eligible for these awards. However, under the Act, no award can be made to the United States or to any creditor of the taxpayer. Thus, for example, awards would not be made to creditors of a taxpayer in interpleaders, wrongful levy actions, and lien priority cases.

Under the Act, the determination of whether the position of the United States was unreasonable is to be made by the court or by agreement of the parties. Congress intended that the determination by the court on this issue is to be made on the basis of the facts and legal precedents relating to the case as revealed in the record. Other factors Congress believed might be taken into account in making this determination include (1) whether the Government used the costs and expenses of litigation against its position to extract concessions from the taxpayer that were not justified under the circumstances of the case, (2) whether the Government pursued the litigation against the taxpayer for purposes of harassment or embarrassment, or out of political motivation, and (3) such other factors as the court finds relevant. Generally, the pursuit of litigation by the Government to establish a conflict among the United States Circuit Courts of Appeals would not be unreasonable.

Congress expected the courts to develop procedures or take action, by court rule or otherwise, concerning the time and manner in which taxpayers' claims for awards of litigation costs are to be made. These procedures could prevent the introduction of evidence on the question of litigation costs until after completion of the trial on the substantive tax issues. In such cases, the court may direct the parties to make further submissions to the court, setting forth the details upon which the claims for litigation costs are based, either before or after the court renders its decision in the case. If such submissions are not made or merely restate a claim based on general allegations, such claim may be dismissed without necessity of any further action.

---

[2] A United States court is any court described in 28 U.S.C. § 451 or the Tax Court.

The amount that may be awarded for litigation costs in any proceeding may not exceed $25,000. This limitation applies regardless of the number of parties to the proceeding or the number of tax years at issue. Congress expected that the courts will reduce the amount of any award, if the taxpayer (and other parties) pursue multiple actions when a single action could have been pursued to decide the controversy. This reduction should be made without regard to the motivation for pursuing multiple actions.

Under the Act, the new Code provision for awards of litigation costs is the exclusive provision for such awards in any civil action or proceeding to which this new provision applies. Thus, taxpayers eligible for an award of litigation costs in tax actions must seek an award under new Code section 7430 and will be denied awards under the Equal Access to Justice Act (P.L. 96-481).[3]

Limitations

(a) Exhaustion of administrative remedies.—The Act provides that no award of reasonable litigation costs shall be made unless the court determines that the prevailing party has exhausted the administrative remedies available within the Internal Revenue Service. This provision of the Act is intended to preserve the role that the administrative appeals process plays in the resolution of tax disputes by requiring taxpayers to pursue such remedies prior to litigation. A taxpayer who actively participates in, and discloses all relevant information during, the administrative stages of the case will be considered to have exhausted the available administrative remedies. Failure to so participate and disclose information may be sufficient grounds for determining that the taxpayer has not exhausted administrative remedies, and, therefore, is ineligible for an award of litigation costs.

Congress recognized that the exhaustion of remedies requirement may be inappropriate in some cases. For example, if a notice of deficiency is issued to a taxpayer in connection with an issue which the Internal Revenue Service has identified as one which it will litigate in all cases, then it would be inappropriate to require an administrative appeal. Therefore, taxpayers are required to exhaust available administrative remedies unless the court determines that, under the circumstances of the case, such requirement is unnecessary.

(b) Costs allocable to the United States.—The Act allows awards of reasonable litigation costs up to $25,000 only to the extent the costs are allocable to the United States and not to any other party to the action or proceeding.

---

[3] The Act does not affect the recovery under section 2412(a) of Title 28 of the court costs enumerated in 28 U.S.C. sec. 1920, as in effect on October 1, 1981.

(c) Excluded actions.—No award for costs may be made with respect to declaratory judgment proceedings except for a proceeding involving the revocation of the determination that an organization is tax-exempt under section 501(c)(3). The excluded actions in which no awards for costs may be made include:

(1) Declaratory judgments with respect to the status and classification of organizations as tax-exempt organizations, qualified charitable donees, private foundations, or private operating foundations (unless the action or proceeding involves the revocation of the determination as to the tax-exempt status of a charitable organization);

(2) declaratory judgments with respect to the initial or continuing qualification of certain retirement plans;

(3) declaratory judgments with respect to whether a transfer of property from a United States person to a foreign corporation has the avoidance of Federal income taxes as one of its principal purposes; and

(4) declaratory judgments with respect to the status of certain governmental obligations for purposes of the income tax exclusion for interest under section 103(a).

(d) Multiple actions.—The Act provides that multiple actions that could have been joined or consolidated, or a case or cases involving a return or returns of the same taxpayer (including joint returns of married individuals) that could have been joined in a single proceeding in the same court, will be treated as one civil proceeding regardless of whether the joinder or consolidation actually occurs, unless the court in which the action is brought determines that it would not be appropriate to treat such actions or cases as joined or consolidated.

Reasonable litigation costs

The Act provides that reasonable litigation costs include (1) court costs, such as docket fees, fees of the court reporter, and fees for printing, (2) the reasonable expenses of expert witnesses in connection with the civil proceeding, (3) the reasonable cost of any study, analysis, engineering report, test, or project which is found by the court to be necessary for the preparation of the party's case, and (4) reasonable fees paid or incurred for the services of attorneys in connection with the civil proceeding. In the case of Tax Court proceedings, fees for the services of an individual (whether or not an attorney) who is authorized to practice before the Tax Court are to be treated as fees for the services of an attorney.

Recoverable litigation costs include only the reasonable amount of costs which are incurred in the litigation of a civil tax action or proceeding. For example, the reasonable amount of fees incurred by a taxpayer for an accountant's study or analysis which is found by the court to be necessary for the preparation of the taxpayer's case is recoverable under an award of litigation costs. Also, the reasonable amount of fees paid by an attorney to another professional for services rendered in connection with the tax litigation may be recoverable. Congress intended that the costs of preparing and filing the petition or complaint which commences a civil tax action be the first of any recoverable attorney's fees. Fees paid or incurred for the services of an attorney during the administrative stages of the case could not be recovered under an award of litigation costs.

Reasonable litigation costs include only those costs incurred by the taxpayer or the taxpayer's representative. Thus, costs incurred by a creditor of the taxpayer or a party to a transaction that gives rise to the substantive tax issue could not be awarded. However, Congress did not expect the court to examine the particular payment arrangement between a taxpayer and his attorneys. Thus, if an attorney is employed on behalf of the taxpayer by a third party such as a section 501(c)(3) organization, those attorney's fees may be recovered by the taxpayer even though the organization initially incurred the expense of retaining the counsel.

The determination of what constitutes a reasonable amount for the expenses, costs, and fees actually incurred by a taxpayer in a civil tax action is to be made by the court hearing the action. The court's determination of the amount of reasonable litigation costs may be made on the basis of detailed affidavits submitted to the court, which state the actual time expended and the rate at which fees and other costs and expenses were computed, without a separate evidentiary hearing on the issue of costs. However, the court, in making its determination as to the reasonable amount of such expenses, costs, and fees, may consider any party's failure to comply with the court's rules requiring stipulation of all facts which fairly should not be in dispute. This consideration is relevant because Congress did not intend to permit awards for litigation costs which the taxpayer could have reduced or avoided through full disclosure of all relevant facts.

Prevailing party

A taxpayer must be the prevailing party in a civil tax proceeding in order to receive an award of litigation costs. The Act provides that a prevailing party is a party (other than the United States or any creditor of the taxpayer involved) which (1) establishes that the position of the United States in the civil proceeding was unreasonable, and (2) has substantially prevailed with respect to the amount in controversy, or has substantially prevailed with respect to the most significant issue, or set of issues, presented. Generally, the decision on the amount in controversy will be determinative; however, tax litigation often involves multiple issue cases. In such cases, one issue may involve a smaller dollar amount than the other issue or issues but may be the most significant issue for the Government or for the taxpayer. This may occur because of the importance of the issue in other transactions or future years. To accommodate this possibility, the Act provides that a prevailing party may be one that prevails on such an issue.

Appeals procedure

An order granting or denying an award of litigation costs, in whole or in part, is to be incorporated as part of the decision or judgment in the case. Congress intended that the order granting or denying an award be appealable in the same manner, and to the same extent, as the decision or judgment in the case. Therefore, when a taxpayer prevails on the merits of the case but is denied an award of litigation costs, the order denying such costs is not separately appealable. Congress expected that when a case is appealed, the appellate court will not substitute its judgment for that of the trial court as to the reasonableness of the amount of the award unless the decision of the trial court is clearly erroneous. Also, when a taxpayer loses in the trial court and obtains a reversal of that decision in the appellate court, the appellate court would not normally award attorney's fees to the taxpayer since the trial court, by definition, had found the Government's position to be reasonable.

Increase in penalty for instituting proceedings for delay, etc.

The Act also provides that if it appears to the Tax Court that proceedings have been instituted or maintained by a taxpayer primarily for delay or that the taxpayer's position in proceedings before the Tax Court is frivolous or groundless, then damages, i.e., a penalty, may be awarded to the United States in an amount not in excess of $5,000.[4]

Effective Date

The litigation costs provisions apply to civil actions or proceedings commenced after February 28, 1983.

The provision relating to awards of damages to the United States in actions instituted or maintained for delay or when the taxpayer's position is frivolous or groundless is effective after December 31, 1982.

Termination.—The litigation costs provisions of the Act will not apply to any proceeding commenced after December 31, 1985. However, the provisions will apply through final disposition of any action or proceedings commenced before January 1, 1986.

Revenue Effect

It is estimated that this provision will increase fiscal year budget outlays by less than $5 million annually.

---

[4] Under Rule 38 of the Federal Rules of Appellate Procedure, the courts of appeal may award "just damages and single or double costs to the appellee" if the appeal is determined to be frivolous.

11. Treatment of certain lending or finance businesses for purposes of the tax on personal holding companies (sec. 293 of the Act and Sec. 542 of the Code)*

Prior Law

Overview

Section 541 of the Code imposes a tax on the undistributed personal holding company income of a personal holding company. A corporation constitutes a personal holding company if at least 60 percent of its adjusted ordinary gross income is personal holding company income and if more than 50 percent of its stock is owned by five or fewer individuals at any time during the last half of the taxable year. Personal holding company income generally is defined as interest, dividends, royalties, rents, and certain other types of passive income.

Exclusion for lending or finance companies

Certain types of corporations, actively engaged in a trade or business which produces income that usually would be considered passive investment income, are excluded from the personal holding company tax provisions. Among the corporations excluded from these provisions are lending or finance companies.

A corporation qualifies as a lending or finance company if 60 percent of its ordinary gross income is derived from the active and regular conduct of a lending or finance business and certain other requirements are satisfied. Under prior law, the term "lending or finance business" was defined, in part, to mean a business of making loans, or purchasing or discounting accounts receivable, notes, or installment obligations, which at the date of the loan or acquisition have a remaining maturity of no more than 60 months. An exception to the 60-month rule is provided for loans, notes, or obligations secured by a security interest in personal property where the security interest arose out of the sale of goods or services in the course of the borrower's or transferor's trade or business.

The personal holding company provisions also apply a business expense test in determining whether a corporation is engaged in the active and regular conduct of a lending or finance business. Under prior law, a corporation did not satisfy this requirement unless the sum of its business deductions[1] directly allocable to its lending or finance business equaled or exceeded 15 percent of the first $500,000 of its ordinary gross income derived from a lending or finance business plus 5 percent of such ordinary gross income from $500,000 to $1 million.[2]

---

*For legislative background of the provision, see H.R. 4961, as reported by the House, sec. 105; H.R. 4717, as reported by the Senate, sec. 103, Cong. Rec. S 15579, S 15589 (December 16, 1981); and H. Rep. No. 97-760 (August 17, 1982), pp. 687-688 (Joint Explanatory Statement of the Committee of Conference).

[1] Business deductions include only (1) deductions which are allowable only by reason of sections 162 or 404 and which do not represent compensation for personal services rendered by shareholders or members of their families and (2) deductions for depreciation and real property taxes to the extent that the property with respect to which such deductions are allowable is used directly in the active and regular conduct of the lending or finance business (sec. 542(d)(2)).

Reasons for Change

Congress was aware that since 1964 (when the rules relating to lending or finance companies were last amended) the nature of the loans made by lending or finance companies has changed. First, these companies have been making loans of longer maturities—primarily second mortgages on real estate and also financing mobile homes. Some of these loans have maturities of up to 144 months. Notwithstanding the length of the loans, the making of these loans by these companies is often done not as part of an investment activity, but rather as part of the active conduct of a trade or business. Second, these companies have made increasing use of loans made in indefinite maturity transactions (e.g. revolving credit loans) which technically may have a maturity which does not meet the "no more than 60 months" requirement. Furthermore, due to the passage of time, the maximum amount needed to satisfy the business expense test has become outdated.

Congress also noted that the recent case of *Omaha Aircraft Leasing Co.*, 74 T.C. 251 (1980) (aff'd. 646 F. 2d 341 (8th Cir. 1981)), involved the issue of whether the taxpayer was engaged in the active and regular conduct of a lending or finance businesss. In addressing the issue of whether the "active and regular" requirement was met, the court considered (1) the number of loans outstanding, (2) the amount of effort and expense required to service the loans, (3) the extent of the taxpayer's activities involving attempts to make new loans, and (4) the duration of periods of inactivity by the taxpayer. The decision of the Tax Court in this case indicates that the "active and regular" requirement, coupled with the business expense test (as modified by the Act), should be sufficient to insure that the lending or finance company provisions will not apply to "incorporated pocketbooks," which are essentially passive investment entitites, even if loans with longer maturities are permitted.

Accordingly, Congress believed that the definition of the term "lending or finance" business should be modified to include the business of making revolving credit loans and loans with maximum maturities of 144 months and that the business expense test of present law should be modified by increasing the maximum amount needed to satisfy the test.

Explanation of Provision

The Act modifies both the 60-month maturity limitation and the business expense requirement of the lending or finance company exception to the personal holding company provisions.

The Act broadens the definition of a lending or finance business to include the business of making or acquiring loans with maturities of up to 144 months and to include the business of making or acquiring loans, notes, or installment obligations made in indefinite maturity credit transactions. Indefinite maturity credit transactions are defined as such loans, notes or installment obligations made under an agreement which provides that the creditor will make loans or advances (not in excess of an agreed upon maximum amount) from time to time for the account of the debtor upon request and which provides that the debtor may repay the loan, or advance, in full or in installments.

---

[2] Thus, the maximum amount of expenses necessary to meet this test is $100,000 (15 percent of $500,000 or $75,000 plus 5 percent of $500,000 or $25,000, for a total of $100,000).

The Act also modifies the amount of business expenses required in determining whether a corporation with more than $1 million in ordinary gross income from a lending or finance business is a lending or finance company. For taxable years beginning after December 31, 1981, a corporation satisfies the business expense test only if its qualifying business expenses equal or exceed 15 percent of the first $500,000 of ordinary gross income derived from a lending or finance business, plus 5 percent of such ordinary gross income in excess of $500,000.

Effective Date

The provisions changing the maturity of eligible loans apply to taxable years beginning after December 31, 1980.

The provisions increasing the business expense requirement apply to taxable years beginning after December 31, 1981.

Revenue Effect

It is estimated that this provision will reduce budget receipts by less than $5 million annually.

V. REVENUE EFFECTS OF THE ACT

The estimated revenue effects of the tax provisions of the Act are presented in tables V-1 through V-4. Tables V-1 and V-2 summarize the effects of the Act on fiscal year budget receipts and on calendar year tax liabilities, respectively. Table V-3 shows in more detail the revenue effects on fiscal year budget receipts, and table V-4 provides detailed information on calendar year tax liabilities.

As shown in table V-1, the revenue provisions involving statutory changes are estimated to increase net budget receipts by $15.9 billion in fiscal year 1983, $35.3 billion in 1984, $40.3 billion in 1985, $50.5 billion in 1986, and $63.3 billion in fiscal year 1987. Together with the additional revenue anticipated from IRS staff increases,[1] the Act raises $18.0 billion in fiscal year 1983, $37.7 billion in 1984, $42.7 billion in 1985, $51.8 billion in 1986 and $63.9 billion in 1987.[2]

The total revenue raised during the first three fiscal years, 1983 through 1985, amounts to $98.3 billion, the revenue increase target mandated for this period by the First Concurrent Resolution on the Budget for Fiscal Year 1983.

The estimates shown here are the same as those used in the Conference Report on H.R. 4961. Although most of the figures would not change if the revenue effects of the provisions in the Act were reestimated, in some cases estimates made now would differ from those in the report because additional information has become available.

---

[1] The Administration budget requests additional IRS staff which is expected to raise revenues by $2.1 billion in fiscal year 1983, $2.4 billion in 1984. and $2.4 billion in 1985. The legislative history of the First Concurrent Resolution on the Budget for Fiscal Year 1983 indicates that the revenue target in that resolution assumed that these staff increases would take place.

[2] These totals do not include the revenue effect of title VI (sec. 611) of the Act, which lowers the income threshold above which the exclusion for unemployment compensation phases out. That provision raises $0.8 billion in fiscal year 1983, $0.7 billion in 1984, $0.6 billion in 1985, $0.6 billion in 1986 and $0.7 billion in 1987.

Table V-1.—Summary of Estimated Revenue Effects of Tax Equity and Fiscal Responsibility Act of 1982 (H.R. 4961), Fiscal Year Receipts, 1983–87

[In millions of dollars]

	1983	1984	1985	1986	1987
Individual income tax provisions	272	3,113	3,106	3,336	3,556
Business tax provisions	5,422	13,292	16,497	28,042	40,116
Pension provisions	194	780	870	970	1,058
Life insurance and annuities provisions	1,942	2,155	2,920	3,138	3,370
Employment tax provisions	1,904	3,083	3,577	2,853	2,572
Excise tax provisions	2,798	4,009	4,702	2,054	1,472
Miscellaneous provisions	−38	−37	−34	−32	−30
Compliance provisions	3,365	8,869	8,660	10,174	11,217
Total, tax provisions [1]	**15,859**	**35,264**	**40,298**	**50,535**	**63,331**
Revenue gain resulting from additional IRS enforcement personnel	2,100	2,400	2,400	1,300	600
Grand total, all provisions [1]	**17,959**	**37,664**	**42,698**	**51,835**	**63,931**

---

[1] These totals do not include taxes increased under Title VI (sec. 611), which reduces the income thresholds for inclusion of unemployment benefits in adjusted gross income. The estimated amounts of increased taxes under this provision are $763 million in 1983, $734 million in 1984, $611 million in 1985, $618 million in 1986, and $650 million in 1987.

Table V-2.—Summary of Estimated Revenue Effects of Tax Equity and Fiscal Responsibility Act of 1982 (H.R. 4961), Calendar Year Tax Liabilities; 1982-87

[In millions of dollars]

	1982	1983	1984	1985	1986	1987
Individual income tax provisions		3,137	3,088	3,314	3,527	3,920
Business tax provisions	679	8,363	12,917	19,099	36,971	43,410
Pension provisions		767	802	983	1,029	1,106
Life insurance and annuities provisions	1,238	1,461	2,831	3,037	3,260	3,502
Employment tax provisions		2,989	3,155	2,998	2,663	2,704
Excise tax provisions	359	3,798	4,123	4,427	1,370	1,540
Miscellaneous provisions	−15	−38	−35	−33	−31	−30
Compliance provisions	83	4,031	7,223	8,823	10,050	11,014
Total, tax provisions [1]	**2,344**	**24,508**	**34,104**	**42,648**	**58,839**	**67,166**
Revenue gain resulting from additional IRS enforcement personnel	700	2,500	2,500	2,000	1,100	
Grand total, all provisions [1]	**3,044**	**27,008**	**36,604**	**44,648**	**59,939**	**67,166**

---

[1] These totals do not include taxes increased under Title VI (sec. 611), which reduces the income thresholds for inclusion of unemployment benefits in adjusted gross income. The estimated amounts of increased taxes under this provision are $763 million in 1982, $734 million in 1983, $611 million in 1984, $618 million in 1985, $650 million in 1986 and $668 million in 1987.

Table V-3.—Estimated Revenue Effects of Tax Provisions of Tax Equity and Fiscal Responsibility Act of 1982 (H.R. 4961), Fiscal Year Receipts, 1983-87

[In millions of dollars]

Provision	1983	1984	1985	1986	1987
Provisions Relating to Individuals					
Sec. 201--Alternative minimum tax	(1)	659	701	741	729
Sec. 202—Medical expense deduction	272	1,788	1,671	1,795	1,947
Sec. 203—Ten-percent casualty deduction floor		666	734	800	880
Total, provisions relating to individuals	**272**	**3,113**	**3,106**	**3,336**	**3,556**
Provisions Primarily Relating to Business					
Sec. 204—Reduction in certain corporate preference items	515	936	948	918	995
Sec. 205(a)—Investment tax credit basis adjustment	362	1,374	2,658	4,109	5,579
Sec. 205(b)—Limit ITC to 85 percent of tax liability	152	259	213	178	164
Sec. 206—Repeal of 1985 and 1986 increases in accelerated cost recovery deductions			1,541	9,907	18,442
Sec. 207—Construction period interest and taxes	555	1,179	1,206	1,084	819
Secs. 208-210—Modifications to safe harbor leasing rules	1,036	2,649	4,252	5,496	7,000
Secs. 211-212—Changes in taxation of foreign oil extraction income	200	438	508	569	621
Sec. 213—Limit on possessions credit	201	428	473	516	559
Secs. 214-221—Private purpose tax-exempt bonds	63	261	539	748	1,076
Secs. 222-228—Mergers and acquisitions	427	749	959	1,014	1,064
Sec. 229—Completed contracts	882	2,235	2,535	2,390	2,559
Sec. 230—Annual accounting method for certain joint ventures					

Table V-3.—Estimated Revenue Effects of Tax Provisions of Tax Equity and Fiscal Responsibility Act of 1982 (H.R. 4961), Fiscal Year Receipts, 1983-87—Continued

[In millions of dollars]

Provision	1983	1984	1985	1986	1987
Secs. 231-232—Original issue discount and coupon stripping provisions	163	310	465	629	808
Sec. 233—Targeted jobs credit	−182	−551	−591	−271	−54
Sec. 234—Accelerated corporate tax payments	1,048	3,025	791	755	484
Total, provisions primarily relating to business	**5,422**	**13,292**	**16,497**	**28,042**	**40,116**
Pension Provisions (Secs. 235-254)	**194**	**780**	**870**	**970**	**1,058**
Taxation of Life Insurance Companies and Annuities (Secs. 255-268)	**1,942**	**2,155**	**2,920**	**3,138**	**3,370**
Employment Tax Provisions					
Secs. 269-270—Independent contractors	−117	−107	−79	−85	−92
Secs. 271-277—FUTA tax	1,404	2,353	2,729	1,872	1,501
Sec. 278—Federal employees medicare tax [3]	617	837	927	1,066	1,163
Total, employment tax provisions	**1,904**	**3,083**	**3,577**	**2,853**	**2,572**
Excise Tax Provisions					
Secs. 279-281A—Airport and airway taxes [4]	817	962	1,089	1,216	1,357
Sec. 282—Telephone tax [5]	616	1,073	1,600	730	....
Sec. 283—Cigarette tax [6]	1,275	1,829	1,859	−34	−13
Sec. 284—Repeal of Trans Alaska Pipeline System adjustment [7]	90	145	154	142	128
Total, excise tax provisions	**2,798**	**4,009**	**4,702**	**2,054**	**1,472**

Miscellaneous Provisions					
Sec. 285—Two-year extension of exclusion from gross income of national research service awards	−8	−7	−4	−2	
Sec. 286—Special rules for certain amateur sports organizations	(2)	(2)	(2)	(2)	(2)
Sec. 287—New Jersey general revenue sharing allocation					
Sec. 288—Illegal payments to government officials or employees	−30	−30	−30	−30	−30
Sec. 290—Jefferson County mental health center	(8)				
Sec. 291—Alaska Native Corporations					
Sec. 292—Awarding of costs and certain fees to attorneys	(9)	(9)	(9)	(9)	
Sec. 293—Treatment of certain lending of finance businesses for tax on personal holding companies	(2)	(2)	(2)	(2)	(2)
Sec. 294—Additional refunds relating to repeal of excise tax on buses	(1)	(1)			
Sec. 354—Exemption of Veterans organizations	(2)	(2)	(2)	(2)	(2)
Total, miscellaneous provisions	**−38**	**−37**	**−34**	**−32**	**−30**
Compliance Provisions					
Secs. 301-308—Withholding on interest and dividends	1,344	5,246	3,975	4,605	5,181
Secs. 309-353; 355-358; 401-406—Other compliance provisions; partnership audits [10]	2,021	3,623	4,685	5,569	6,036
Total, compliance provisions	**3,365**	**8,869**	**8,660**	**10,174**	**11,217**
Total, tax provisions	**15,859**	**35,264**	**40,298**	**50,535**	**63,331**
Revenue gain resulting from additional IRS enforcement personnel	2,100	2,400	2,400	1,300	600
Grand total, all provisions [11]	**17,959**	**37,664**	**42,698**	**51,835**	**63,931**

[1] Negligible.

[2] Loss of less than $5 million.

[3] This provision also will reduce outlays by approximately $122 million in fiscal year 1983, $163 million in 1984, $176 million in 1985, $199 million in 1986, and $213 million in 1987.

[4] The figures represent net increases, after accounting for lower income tax receipts. Additional revenues from aviation excise taxes resulting from this bill before taking account of the income tax offset are estimated at $1,089 million in 1983, $1,283 million in 1984, $1,452 million in 1985, $1,621 million in 1986, and $1,809 million in 1987.

[5] The figures represent net increases, after accounting for lower income tax receipts. Increases in general fund receipts from this tax before taking account of the income tax offset are estimated at $821 million in fiscal year 1983, $1,431 million in 1984, $2,133 million in 1985, and $973 million in 1986.

[6] The figures represent net increases, after accounting for lower income tax receipts. Increases in general fund receipts from this tax before taking account of the income tax offset are estimated at $1,700 million in fiscal year 1983, $2,439 million in 1984, and $2,479 million in 1985.

[7] The figures represent net increases, after accounting for lower tax receipts. Increases in general fund receipts from this tax before taking account of the income tax offset are estimated at $139 million in fiscal year 1983, $260 million in 1984, $285 million in 1985, $267 million in 1986, and $241 million in 1987.

[8] Increases outlays by $50,000.

[9] Increases outlays by less than $5 million.

[10] Additional gains in budget receipts are expected from the Administration's proposal to increase IRS personnel in taxpayer compliance enforcement activities: $2.1 billion in fiscal year 1983, $2.4 billion in 1984, $2.4 billion in 1985, $1.3 billion in 1986, and $0.6 billion in 1987.

[11] These totals do not include taxes increased under Title VI, which reduces the income thresholds for inclusion of unemployment benefits in adjusted gross income. The estimated amounts of increased taxes under this provision are $763 million in fiscal year 1983, $734 million in 1984, $611 million in 1985, $618 million in 1986, and $650 million in 1987.

Table V-4.—Estimated Revenue Effects of Tax Provisions of Tax Equity and Fiscal Responsibility Act of 1982 (H.R. 4961), Calendar Year Tax Liabilities, 1982–87

[In millions of dollars]

Provision	1982	1983	1984	1985	1986	1987
Provisions Relating to Individuals						
Sec. 201—Alternative minimum tax		659	701	741	729	817
Sec. 202—Medical expense deduction		1,812	1,653	1,773	1,918	2,114
Sec. 203—Ten-percent casualty deduction floor [1]		666	734	800	880	989
Total, provisions relating to individuals		**3,137**	**3,088**	**3,314**	**3,527**	**3,920**
Provisions Primarily Relating to Business						
Sec. 204—Reduction in certain corporate preference items		948	941	833	807	905
Sec. 205(a)—Investment tax credit basis adjustment		757	2,070	3,389	4,897	6,334
Sec. 205(b)—Limit ITC to 85 percent of tax liability		287	235	185	162	134
Sec. 206—Repeal of 1985 and 1986 increases in accelerated cost recovery deductions				3,197	17,575	19,899
Sec. 207—Construction period interest and taxes		1,110	1,249	1,163	1,006	635
Secs. 208-210—Modifications to safe harbor leasing rules	463	2,130	3,723	5,189	6,475	8,241
Secs. 211-212—Changes in taxation of foreign oil extraction income		401	473	545	592	645

Table V-4.—Estimated Revenue Effects of Tax Provisions of Tax Equity and Fiscal Responsibility Act of 1982 (H.R. 4961), Calendar Year Tax Liabilities, 1982-87—Continued

[In millions of dollars]

Provision	1982	1983	1984	1985	1986	1987
Sec. 213—Limit on possessions credit		402	454	492	540	578
Secs. 214-221—Private purpose tax-exempt bonds	2	136	404	692	819	1,368
Secs. 222-228—Mergers and acquisitions	149	556	942	976	1,052	1,079
Sec. 229—Completed contracts		1,763	2,773	2,331	2,427	2,693
Sec. 230—Annual accounting method for certain joint ventures						
Secs. 231-232—Original issue discount and coupon stripping provisions	65	238	390	549	719	907
Sec. 233—Targeted jobs credit		−365	−737	−442	−100	−8
Sec. 234—Accelerated corporate tax payments						
Total, provisions primarily relating to business	**679**	**8,363**	**12,917**	**19,099**	**36,971**	**43,417**
Pension Provisions (Secs. 235-254)		**767**	**802**	**983**	**1,029**	**1,106**
Taxation of Life Insurance Companies and Annuities (Secs. 255-268)	**1,238**	**1,461**	**2,831**	**3,037**	**3,260**	**3,502**
Employment Tax Provisions						
Secs. 269-270—Independent contractors		−35	−56	−63	−70	−77

Secs. 271-277—FUTA tax		2,223	2,355	2,104	1,626	1,590
Sec. 278—Federal employees medicare tax		801	856	957	1,107	1,191
Total, employment tax provisions		**2,989**	**3,155**	**2,998**	**2,663**	**2,704**
Excise Tax Provisions						
Secs. 279-281A—Airport and airway taxes [3]	280	879	1,014	1,136	1,269	1,415
Sec. 282—Telephone tax [4]		1,002	1,116	1,901	......	......
Sec. 283—Cigarette tax [5]	79	1,801	1,839	1,236	−38	......
Sec. 284—Repeal of Trans Alaska Pipeline System adjustment [6]		116	154	154	139	125
Total, excise tax provisions	**359**	**3,798**	**4,123**	**4,427**	**1,370**	**1,540**
Miscellaneous Provisions						
Sec. 285—Two-year extension of exclusion from gross income of national research service awards	−5	−8	−5	−3	−1	......
Sec. 286—Special rules for certain amateur sports organizations	(2)	(2)	(2)	(2)	(2)	(2)
Sec. 287—New Jersey general revenue sharing allocation	......	......	......	......	......	......
Sec. 288—Illegal payments to government officials or employees	−10	−30	−30	−30	−30	−30
Sec. 290—Jefferson County mental health center [7]	......	......	......	......	......	......
Sec. 291—Alaska Native Corporations	......	......	......	......	......	......
Sec. 292—Awarding of costs and certain fees to attorneys		(8)	(8)	(8)	(8)	......

Table V-4.—Estimated Revenue Effects of Tax Provisions of Tax Equity and Fiscal Responsibility Act of 1982 (H.R. 4961), Calendar Year Tax Liabilities, 1982–87—Continued

[In millions of dollars]

Provision	1982	1983	1984	1985	1986	1987
Sec. 293—Treatment of certain lending of finance businesses for tax on personal holding companies	(2)	(2)	(2)	(2)	(2)	(2)
Sec. 294—Additional refunds relating to repeal of excise tax on busses						
Sec. 354—Exemption of veterans organizations		(2)	(2)	(2)	(2)	(2)
Total, miscellaneous provisions	**−15**	**−38**	**−35**	**−33**	**−31**	**−30**
Compliance Provisions						
Secs. 301–308—Withholding on interest and dividends		1,876	3,432	3,985	4,634	5,077
Secs. 309–35; 355–358; 401–406—Other compliance provisions; partnership audits [9]	83	2,155	3,791	4,838	5,416	5,937
Total, compliance provisions	**83**	**4,031**	**7,223**	**8,823**	**10,050**	**11,014**
Total, tax provisions	**2,344**	**24,508**	**34,104**	**42,648**	**58,839**	**67,166**

Revenue gain resulting from additional IRS enforcement personnel [10]	700	2,500	2,500	2,000	1,100	…………………
Grand total, all provisions [11]	**3,044**	**27,008**	**36,604**	**44,648**	**59,939**	**67,166**

---

[1] Negligible.

[2] Loss of less than $5 million.

[3] The figures represent net increases, after accounting for lower income tax receipts. Additional revenues from aviation excise taxes resulting from this bill before taking account of the income tax offset are estimated at $374 million in 1982, $1,172 million in 1983, $1,351 million in 1984, $1,514 million in 1985, $1,692 million in 1986, and $1,887 million in 1987.

[4] The figures represent net increases, after accounting for lower income tax receipts. Increases in general fund receipts from this tax before taking account of the income tax offset are estimated at $1,336 million in calendar year 1983, $1,488 million in 1984 and $2,535 million in 1985.

[5] The figures represent net increases, after accounting for lower income tax receipts. Increases in general fund receipts from this tax before taking account of the income tax offset are estimated at $79 million in calendar year 1982, $2,401 million in 1983, $2,452 million in 1984 and $1,648 million in 1985.

[6] The figures represent net increases, after accounting for lower income tax receipts. Increases in general fund receipts from this tax before taking account of the income tax offset are estimated at $214 million in calendar year 1983, $285 million in 1984, $285 million in 1985, $257 million in 1986, and $232 million in 1987.

[7] Increases outlays by $50,000.

[8] Increases outlays by less than $5 million.

[9] Additional increases in tax liabilities are expected from the Administration's proposal to increase IRS personnel in taxpayer compliance enforcement activities.

[10] These figures represent additional tax liability in the year during which it is enforced rather than the year during which it was incurred.

[11] These totals do not include taxes increased under Title VI, which reduces the income thresholds for inclusion of unemployment benefits in adjusted gross income. The estimated amounts of increased taxes under this provision are $763 million in 1982, $734 million in 1983, $611 million in 1984, $618 million in 1985, $650 million in 1986 and $668 million in 1987.